



THE UNIVERSITY  
OF ARIZONA®

James E. Rogers College of Law

# *Arizona Legal Studies*

Discussion Paper No. 09-35

## **Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis**

Brent T. White  
The University of Arizona  
James E. Rogers College of Law

October 2009

**Underwater and Not Walking Away:  
Shame, Fear and the Social Management of the Housing Crisis**  
Brent T. White\*

*Abstract*

*Contrary to reports that homeowners are increasingly “walking away” from their mortgages, most homeowners continue to make their payments even when they are significantly underwater. This article suggests that most homeowners do not strategically default as a result of two emotional forces: 1) the desire to avoid the shame and guilt of foreclosure; and 2) exaggerated anxiety over foreclosure’s perceived consequences. Moreover, these emotional constraints are actively cultivated by the government and other social control agents in order to induce homeowners to ignore market and legal norms under which strategic default might not only be a viable option, but also the wisest financial decision. Unlike lenders, individual homeowners have thus generally not acted to minimize their losses and have born a disproportionate share of the burden from the housing collapse.*

**TABLE OF CONTENTS**

I.	Introduction.....	1
II.	Underwater and Staying Put .....	3
III.	The Financial Logic of Walking Away .....	7
IV.	Explaining Homeowner Choices .....	13
V.	The Social Control of the Housing Crisis .....	23
VI.	The Asymmetry of Homeowner and Lender Norms .....	35
VII.	Leveling the Playing Field.....	40

---

\* Associate Professor Law, University of Arizona, James E. Rogers College of Law.

## I. Introduction

Millions of homeowners in the United States are “underwater” on their mortgages, meaning that they owe more than their homes are worth.<sup>1</sup> Yet, despite all the uproar over homeowners who are simply “walking away” from their homes,<sup>2</sup> the vast majority of underwater homeowners continue to make their mortgage payments - even when they are hundreds of thousands of dollars underwater and have no reasonable prospect of recouping their losses. This includes underwater homeowners that live in “non-recourse states” such as California and Arizona, where lenders cannot pursue defaulting homeowners for a deficiency judgment.

While such behavior may appear irrational,<sup>3</sup> behavioral economists explain that underwater homeowners simply suffer from the same kind of cognitive biases that lead individuals to make other irrational economic decisions.<sup>4</sup> Underwater homeowners aren’t knowingly making bad financial decisions, they just can’t cognitively grasp that they would be better off if they walked away from their mortgages.

The behavioral economic explanation doesn’t account, however, for homeowners who are fully aware that it would be in

---

<sup>1</sup> See, e.g., First American CoreLogic, Negative Equity Report (Aug. 13, 2009)(reporting that 15.2 million U.S. mortgages were underwater in the second quarter of 2009); See also *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts after Six Months*, Congressional Oversight Panel 25 (October 9, 2009)(reporting that between 15-17 million homeowners are, or soon may be, underwater).

<sup>2</sup> See, e.g., David Streitfeld, *When Debtors Decide to Default*, N.Y. TIMES, July 25, 2009; Brian Eckhouse, *More Homeowners Wrestling With Ethics of Walking Away*, LAS VEGAS SUN, March 23, 2009; John A. Schoen, *Why It’s a Bad Idea to Walk Away From the Mortgage*, MSNBC, March 16, 2009; *Fox Business: Some Homeowners Who Can’t Pay Choosing to Just Walk Away* (Fox television broadcast company Feb. 19, 2009); Liz Pulliam Weston, *When to Walk Away From a Mortgage*, MSN MONEY, June 5, 2008; K Barbara Kiviat, *Walking Away From Your Mortgage*, TIME June 19, 2008; 60 Minutes: The U.S. Mortgage Meltdown (CBS broadcast May 25, 2008) available at <http://www.cbsnews.com/video/watch/?id=4126094n&tag=related;photovideo;> *Economy: Why Not Just Walk Away From A Home?* (NPR radio broadcast Feb. 13, 2008) available at <http://www.npr.org/templates/story/story.php?storyId=18958049>

<sup>3</sup> Yongheng Deng & John M. Quigley, *Woodhead Behavior and the Pricing of Residential Mortgages* 3-4 (Berkeley Program on Hous. and Urban Pol., Working Paper No. W00-004, 2004), available at [http://urbanpolicy.berkeley.edu/pdf/DQ\\_Woodhead\\_Web.pdf](http://urbanpolicy.berkeley.edu/pdf/DQ_Woodhead_Web.pdf).

<sup>4</sup> See Peter Ubel, *Human Nature and the Financial Crisis*, FORBES, Feb. 22, 2009, [http://www.forbes.com/2009/02/20/behavioral-economics-mortgage-opinions-contributors\\_financial\\_crisis.html](http://www.forbes.com/2009/02/20/behavioral-economics-mortgage-opinions-contributors_financial_crisis.html).

their financial best interest to default, but still don't do so. This article suggests that most underwater homeowners don't default as a result of two emotional forces: 1) the desire to avoid the shame or guilt associated with foreclosure; and 2) fear over the perceived consequences of foreclosure - consequences that are in actuality much less severe than most homeowners have been led to believe.

Moreover, fear, shame, and guilt are not mere "transaction costs" that homeowners calculate according to their own personal tolerance for each. Rather, these emotional constraints are actively cultivated by the government, the financial industry, and other social control agents in order to induce individual homeowners to act in ways that are *against* their own self interest, but which are - wrongly this article contends - argued to be socially beneficial. Unlike lenders who follow market norms, individual homeowners are encouraged to behave in accordance with social norms of "personal responsibility" and "promise-keeping." Thus, individual homeowners tend to ignore market and legal norms under which strategic default might not only be a viable option but also the wisest financial decision. As a result, individual homeowners have borne a disproportionate share of the costs of the housing meltdown.

This article proceeds as follows: Section II shows that, contrary to widespread concern that underwater homeowners are simply walking away, the vast majority of underwater homeowners have not strategically defaulted on their mortgages. Section III explores the financial logic of walking away from an underwater mortgage and suggests that many more homeowners should be strategically defaulting. Section IV argues that though cognitive biases may account for many underwater homeowners' decisions not to strategically default, emotions such as shame, guilt, and fear play the largest role in homeowner decisions to knowingly eschew "in the money" default options. Section V argues that social control agents such as the government, the media, and the financial industry use both moral suasion and disinformation to cultivate these emotional constraints in homeowners. It also argues that credit rating agencies play a central role as enforcers of moral and social norms against walking away from one's mortgage. Section VI argues that the disparity between the norms governing the behavior of individuals and banks has created an imbalance in which individual homeowners have borne a disproportionate financial burden from the housing collapse. Section VII explores ways to address norm asymmetry between lenders and borrowers and to empower homeowners to renegotiate underwater mortgages on a more level playing field with lenders.

## II. Underwater and Staying Put

As of June 2009, more than 32% of all mortgaged properties in the U.S. were “underwater,” meaning that the homeowner owed more on their mortgage than their home was worth.<sup>5</sup> This percentage is expected to increase to 48% by the first quarter of 2011,<sup>6</sup> by which time housing prices in the largest 100 metropolitan areas are predicted to have dropped 42% from their peak.<sup>7</sup> The national numbers hide the full extent of the problem, however, as the percentage of underwater mortgages is much higher in the regions suffering the worst price declines. For example, as of June 30, 2009, 66 percent of mortgage borrowers were already underwater in Nevada, 51 percent were underwater in Arizona, 49 percent were underwater in Florida, 48 percent were underwater in Michigan, and 42 percent were underwater in California.<sup>8</sup> As shown in the chart below, the percentage of underwater mortgages is higher still if one isolates the hardest hit metropolitan areas:<sup>9</sup>

Metropolitan Statistical Area	Current Percent Underwater
Merced, CA	85
El Centro, CA	85
Modesto, CA	84
Las Vegas, NV	81
Stockton, CA	81
Bakersfield, CA	79
Port St. Lucie, FL	79
Riverside-San Bernardino, CA	78
Cape Coral-Fort Myers, FL	76
Yuba City, CA	73
Madera, CA	72
Fresno, CA	72

<sup>5</sup> First American CoreLogic, Negative Equity Report (Aug. 13, 2009). “The aggregate property value for loans in a negative equity position was \$3.4 trillion.... In California, the aggregate value of homes that are in negative equity was \$969 billion, followed by Florida (\$432 billion), New Jersey (\$146 billion), Illinois (\$146 billion) and Arizona (\$140 billion). Los Angeles had over \$310 billion in aggregate property value in a negative equity position, followed by New York (\$183 billion), Miami (\$152 billion), Washington, DC (\$149 billion) and Chicago (\$134 billion).” *Id.*

<sup>6</sup> Drowning in Debt – A Look at “Underwater” Homeowners 4, Deutsche Bank, August 5, 2009. (on file with author)(also noting that “41% of prime conforming borrowers and 46% of prime jumbo borrowers will be underwater”)

<sup>7</sup> Update: The Outlook For U.S. Home Prices, Deutsche Bank, June 15, 2009 (on file with author)

<sup>8</sup> First American CoreLogic, Negative Equity Report (Aug. 13, 2009).

<sup>9</sup> Percentages from *Drowning in Debt*, *supra* note 6.

## Underwater and Not Walking Away

Orlando-Kissimmee, FL	71
Visalia-Porterville, CA	70
Miami-Miami Beach, FL	70
Palm Bay-Titusville, FL	69
Lakeland-Winter Haven, FL	69
Phoenix-Mesa-Scottsdale, AZ	68

As of the second quarter of 2009, over 16% of homeowners had negative equity exceeding 20% of their home's value, and over 22% of homeowners had negative equity exceeding 10% of their home's value.<sup>10</sup> Again, however, the situation is worse in the hardest hit markets. For example, 47% percent of homeowners in Nevada had negative equity exceeding 25% of their home's value, as did 30% of homeowners in Florida, 29% in Arizona, and 25% in California. Moreover, given the high median home prices at the peak within these markets, a large percentage of these homeowners are underwater by hundreds of thousands of dollars.<sup>11</sup>

The extent of the negative equity problem is a significant contributing factor to a combined foreclosure and 30+ day delinquency rate for home mortgages exceeding 13 percent, a historic high.<sup>12</sup> However, the high foreclosure and delinquency

---

<sup>10</sup> First American CoreLogic, Negative Equity Report (Aug. 13, 2009).

<sup>11</sup> Id. For example, a homeowner who bought a home in 2006 in Salinas, California, where home prices have dropped 70% from the peak, has on average \$214,000 in negative equity. Luigi Guiso, Paola Sapienza & Luigi Zingales, *Moral and Social Constraints to Strategic Default on Mortgages 2* (Nat'l Bureau of Econ. Research, Working Paper No. 15145, July 2009) Moreover, given that average home prices reached over \$580,000 in Salinas at the peak, homeowners who bought even slightly better-than-average homes could easily have negative equity exceeding \$300,000. The story is the same, of course, in other California metro areas, including Los Angeles, Modesto, El Centro, Merced, Riverside, and Redding. The situation is also dire outside of California. A homeowner who bought an average home near the peak in Las Vegas for example – where prices have dropped 52% - would likely have negative equity in excess of \$120,000. The situation is the same in Miami where prices are down 48%, and in Phoenix, where prices have dropped 54%. Furthermore, with such significant price decreases in each of these markets, a large number of individuals who bought more-expensive-than-average homes have negative equity easily topping \$200,000 to \$300,000. Standard & Poor's/Case-Schiller, Home Price Values for July 2009 (Sep. 29, 2009)(on file with author)

<sup>12</sup> As of the second quarter of 2009, the foreclosure rate was 4.3 percent and the delinquency rate (meaning here loans that were 30+ days delinquent) was 8.86 percent, for a combined rate of 13.13. "The delinquency rate includes loans that are at least one payment past due but does not include loans somewhere in the process of foreclosure." Mortgage Bankers Association, National Delinquency Survey 2009 2nd Quarter (Aug. 20, 2009). See also Christopher L Foote,., Kristopher S. Gerardi, Lorenz Goette, and Paul S. Willen, *Reducing Foreclosures 5*, Public Policy Discussion Papers, April 8, 2009 (noting that the empirical evidence on the role of negative equity in contributing

rate is not caused by large percentages of homeowners voluntarily walking from their homes, even though they can afford the payments. To the contrary, only about one-fourth of homeowner defaults are strategic, with the other three-fourths triggered by job losses, divorce or other financial difficulties, which when combined with negative equity give homeowners no option but to let go of their homes.<sup>13</sup> In other words, for the vast majority of homeowners, negative equity is a necessary but not a sufficient condition for default. Moreover, the vast majority of defaults have involved subprime<sup>14</sup> or Alt-A loans<sup>15</sup> – with over 47 percent of subprime loans non-performing as of the second quarter of 2009.<sup>16</sup> In contrast, the combined default rate for prime loans was only 5.44 percent.<sup>17</sup> Put in perspective, these statistics mean that though more than 32% of U.S. homeowners were underwater on their mortgages by the end of the second quarter of 2009, the strategic default rate was roughly 3%.<sup>18</sup>

---

to foreclosures is “incontrovertible.”) Available at <http://www.bos.frb.Org/economic/ppdp/2009/ppdp0902.htm>

<sup>13</sup> Guiso et al., *supra* note 11, at 1; see News Release, Federal Housing Finance Agency, FHFA Reports Fannie Mae and Freddie Mac Foreclosure Prevention Efforts for May (Aug. 3, 2009), [http://www.fhfa.gov/webfiles/14723/MayForeclosure\\_Prevention8309.pdf](http://www.fhfa.gov/webfiles/14723/MayForeclosure_Prevention8309.pdf) (noting that the top five reasons for delinquency are income loss (34%), excessive obligations (20%), unemployment (8%), illness of principal mortgagor (6%), and marital difficulties (6%).”)

<sup>14</sup> A mortgage loan is subprime if the borrower has an imperfect credit history and/or high debt-to-income ratio. “Subprime borrowers generally have a credit (FICO) score between 580 and 660.” *Drowning in Debt – A Look at “Underwater” Homeowners* 3, Deutsche Bank, August 5, 2009

<sup>15</sup> Mortgage Bankers Association, National Delinquency Survey 2009 2nd Quarter (Aug. 20, 2009) “Alt-A loans were typically originated with reduced documentation to home borrowers with limited credit history... Alt-A borrowers have higher FICO scores (660-720) than subprime borrowers. Also, relatively high concentrations of investor properties are common in securitizations of Alt-A mortgage loans.” *Drowning in Debt – A Look at “Underwater” Homeowners* 3, Deutsche Bank, August 5, 2009.

<sup>16</sup> Laurie Goodman, et. al., *Housing Overhang/Shadow Inventory = Enormous Problem* 8, Memorandum, Amherst Mortgage Insight, September 23, 2009 (on file with author)

<sup>17</sup> Mortgage Bankers Association, National Delinquency Survey 2009 2nd Quarter (Aug. 20, 2009) However, as the subprime crisis has mostly run its course, prime fixed-rate loans now account for one in three foreclosure starts. *Id.*

<sup>18</sup> Mortgage Bankers Association, National Delinquency Survey 2009; and *1.9 Million Foreclosure Filings Reported on More than 1.5 Million U.S. Properties in First Half of 2009*, RealtyTrac, (July 15, 2009), <http://www.realtytrac.com/ContentManagement/PressRelease.aspx?channelid=9&ItemID=6802> [hereinafter *Foreclosure Filings Reported*] . For a historical comparison see *Drowning in Debt – A Look at “Underwater” Homeowners* *supra* note \_\_\_ at 14 (noting that 7% of homeowners with negative equity defaulted during the housing bust in Boston in the 1980’s and 90’s)

## Underwater and Not Walking Away

As further evidence that relatively few homeowners strategically default solely because they are underwater, housing markets with a sharply higher percentage of underwater homeowners as compared to the national average do not have sharply higher default rates. For example, although almost 51% of Arizona homeowners were underwater (compared to 32% nationally) in the second quarter of 2009, the combined foreclosure and 30+ day deficiency rate in Arizona was 16.3% – only slightly above the national average of 13%.<sup>19</sup> As the chart below illustrates, this pattern of relatively low default rates compared to the percentage of underwater mortgages holds true almost universally across the hardest hit markets, with the default rate much more closely resembling the unemployment rate than the percent underwater:

<b>Metropolitan Statistical Area</b>	<b>Percent underwater<sup>20</sup></b>	<b>Serious Delinquency Rate<sup>21</sup></b>	<b>Unemployment Rate<sup>22</sup></b>
Merced, CA	85	18.99	17.5
Modesto, CA	84	15.10	16.1
Las Vegas-Paradise, NV	81	15.53	11.3
Stockton, CA	81	16.20	15.5
Bakersfield, CA	79	11.92	13.9
Port St. Lucie, FL	79	17.30	14.1
Riverside-San Bernardino-Ontario, CA	78	15.19	13.7
Orlando-Kissimmee, FL	71	16.63	10.7
Palm Bay-Melbourne-Titusville, FL	69	10.92	11.1
Lakeland-Winter Haven, FL	69	14.05	11.9
Phoenix-Mesa-Scottsdale, AZ	68	10.09	7.7
Tampa-St. Petersburg-Clearwater, FL	65	11.71	11.2
West Palm Beach – Boca Raton, FL	64	15.28	11.2

<sup>19</sup> Mortgage Bankers Association, National Delinquency Survey 2009 2nd Quarter (Aug. 20, 2009)

<sup>20</sup> *Drowning in Debt – A Look at “Underwater” Homeowners* 10, Deutsche Bank, August 5, 2009

<sup>21</sup>The seriously delinquent rate is the combined percentage of mortgages more than 90 days delinquent or in foreclosure. *Risk View: Spatial Patterns of Mortgage Delinquency in Major U.S. Metropolitan Areas*, First American CoreLogic Newsletter, June 2009 (on file with author)

<sup>22</sup> *Update: The Outlook For U.S. Home Prices* 24-25, Deutsche Bank, June 15, 2009

Salinas, CA	51	12.62	11.7
-------------	----	-------	------

These numbers strongly suggest that factors other than strategic defaults are driving the delinquency rate, with unemployment the most likely culprit.<sup>23</sup> Indeed, given the striking disparity between the percentage of underwater homeowners and the percentage of defaults, the real mystery is not - as media coverage has suggested - why large numbers of homeowners are walking away, but why, given the percentage of underwater mortgages, more homeowners are not.<sup>24</sup>

### III. The Financial Logic of Walking Away

Before examining why more underwater homeowners are not strategically defaulting, it might be helpful to explore why they should. A textbook premise of economics is that the value of a home, even an owner occupied one, is “the current value of the rent payments that could be earned from renting the property at market prices.”<sup>25</sup> In other words, when the net cost of buying a

<sup>23</sup> See *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts after Six Months*, Congressional Oversight Panel 20-21 (discussing “fifth wave” of foreclosures caused by unemployment); *Update: The Outlook For U.S. Home Prices* 9, Deutsche Bank, March 15, 2009 (on file with author)(discussing the role of unemployment as the primary risk factor for default.); and Alan Zibel, *Foreclosures rise 5 percent from summer to fall*, ASSOCIATED PRESS WIRE, October 15, 2009 (on file with author)(reporting that “Unemployment is the main reason homeowners are falling into trouble. While the economy is likely out of recession, the unemployment rate — now at a 26-year high of 9.8 percent — isn't expected to peak until the middle of next year.”) Information for the Miami-Fort Lauderdale area is excluded from this chart due to the high concentration of non-owner occupied investment properties in the Miami-Fort Lauderdale area area, resulting in a deficiency rate more than double the unemployment rate. See Kate Barry, *Wary of Default, Banks Curtail Loans to Investors*, American Banker, October 13, 1009 (nothing that, many real estate investors “in second-home markets” such as Miami . Las Vegas, and Phoenix “simply turned in their keys to banks, defaulting on scores of second homes and investment properties that they had intended to flip.”) See also *Drowning in Debt – A Look at “Underwater” Homeowners* 10, Deutsche Bank, August 5, 2009 (listing underwater percentage for the Miami MSA of 70 percent and 69 percent for the Fort Lauderdale MSA); Risk View: Spatial Patterns of Mortgage Delinquency in Major U.S. Metropolitan Areas, First American CoreLogic Newsletter, June 2009 (on file with author) (listing serious delinquency rate for the Miami MSA of 22.14 percent and 18.12 percent for the Fort Lauderdale MSA); and *Update: The Outlook For U.S. Home Prices* 25, Deutsche Bank, June 15, 2009 (listing unemployment rate in Miami of 8.5 percent and 9.3 percent in the Fort Lauderdale MSA).

<sup>24</sup> For examples of the media hype regarding the purported walk away phenomenon see, *supra* note 1.

<sup>25</sup> HYE JIN RHO, ET. AL., CHANGING PROSPECTS FOR BUILDING HOME EQUITY 3, (2008), available at

home exceeds the net cost of renting, one is better off renting. The equation is not as simple, however, as comparing total mortgage payments to rent payments because home ownership carries certain benefits including tax breaks and the potential for appreciation. Additionally, assuming a non-depreciating market, the portion of the mortgage payment that goes to principle rather than interest will eventually inure to the homeowner at the time of sale. On the flip side, homeownership carries significant costs that renting does not, including maintenance, homeowner's insurance and substantial transaction costs upon selling.

In calculating whether to buy or rent, a potential homebuyer should compare the net cost of owning to the net cost of renting a similar home over the expected period of occupancy. The costs of owning include the interest-only portion of the loan payment, property taxes, maintenance, homeowners insurance, and transaction costs upon selling, minus the expected appreciation and cumulative tax savings over the planned period of ownership. As a rule of thumb, a potential homebuyer is generally better off renting when the home price exceeds 15 or 16 times the annual rent for comparable homes.<sup>26</sup>

The calculation for a rational homeowner in deciding whether to strategically default on a home mortgage is similar to that for buying in that base calculation is still the cost of renting verses the cost of continuing to own.<sup>27</sup> However, the underwater homeowner has additional considerations, including existing negative equity on the one hand and the costs of foreclosure on the other.<sup>28</sup> Even leaving aside these foreclosure costs, the calculation as to whether one is financially better off defaulting requires one to consider several additional variables for which one may not have good information. These variables include a reasonable estimate of the current value of one's home, the cost to rent a similar home, an idea of how long one intends to stay in the home, and an estimate of the average appreciation or depreciation one's home is likely to experience over that period of time. While each variable

---

[http://www.cepr.net/documents/publications/Changing\\_Prospect\\_for\\_Building\\_Home\\_Equity\\_2008\\_10.pdf](http://www.cepr.net/documents/publications/Changing_Prospect_for_Building_Home_Equity_2008_10.pdf)

<sup>26</sup> *Id.* at 4. Historical home prices have hewed to a price-to-annual-rent ratio of roughly 15 to 1 - except during bubbles. *Id.*

<sup>27</sup> As a caveat, for homeowners with sufficient resources to purchase another home before bailing on the first, the calculation might actually be the cost of buying a new home (rather than renting) verse continuing to own their current home. See Nick Timiraos, *Some Buy a New Home and Bail on the Old*, Wall St. J., June 11, 2008.

<sup>28</sup> See, Joshua Rosner, *Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt* (June 29, 2001); available at SSRN: <http://ssrn.com/abstract=1162456> (discussing how lack of equity changes the default calculation)

requires some guessing, there is a wealth of information available to assist homeowners in making rational estimates – should they endeavor to do so.<sup>29</sup>

With these estimates in hand, a homeowner also needs to know the current principle balance on their mortgage(s), the monthly interest-only portion of the mortgage(s), monthly mortgage insurance, if any, the amount monthly taxes, insurance, and homeowners association dues, if any, and their annual tax savings from owning versus renting. A rational homeowner can then make relatively simple calculations as to how much money they would save or lose by walking away, both on a monthly basis and over time. They can also predict out how long it will take to recover their equity.<sup>30</sup>

Consider, for example, Sam and Chris, a young professional couple with two small children, who stretched to buy their first home - an average 3 bedroom, 1380 square foot house in Salinas, California – for \$585,000 in January of 2006.<sup>31</sup> Sam and Chris had excellent credit and a solid income, and were thus able to qualify for a 30-year fixed interest loan with nothing down. At

---

<sup>29</sup> For example, both Zillow.com and the Home Price Calculator at <http://www.fhfa.gov/> can provide most homeowners with a reasonably accurate estimate of their home's value. Or, if a home is particularly unique, one can have their home appraised by professional appraiser. Similarly, one could have a real estate management company give an estimate as to how much one's home would rent for or simply look in the newspaper and online to see what similar homes are renting for. Moreover, there are considerable amounts of market-specific research available on the internet which can help rational individuals predict the amount of appreciation or depreciation their home is likely to experience over a given period of time. See, e.g., HYE JIN RHO, ET. AL., CHANGING PROSPECTS FOR BUILDING HOME EQUITY (2008), available at [http://www.cepr.net/documents/publications/Changing\\_Prospect\\_for\\_Building\\_Home\\_Equity\\_2008\\_10.pdf](http://www.cepr.net/documents/publications/Changing_Prospect_for_Building_Home_Equity_2008_10.pdf); Where Home Prices Are Hitting Bottom, FORBES.COM, (September 18, 2009) <http://www.forbes.com/2009/09/18/home-prices-bottoming-lifestyle-real-estate-home-prices.html>; and Why Housing Hasn't Bottomed, FORBES.COM, (October 15, 2009) <http://www.forbes.com/2009/10/15/real-estate-ownership-markets-equities-renting.html>. Or a rational individual in a non-depreciating market might simply count on appreciation around the historical home appreciation rate of 3-4% per year. HYE JIN RHO, ET. AL, *supra* note 27.

<sup>30</sup> For the mathematically challenged, there are online calculators, such as one at YouWalkAway.com, that do these calculations automatically. See, <http://www.youwalkaway.com/output24/InteractiveFlashCalculator.html> (last visited Sep. 26, 2009).

<sup>31</sup> This example is a hypothetical based upon the peak cost of an average priced, and average sized, home in Salanis in January 2006. See Zillow, Salinas Overview, [http://www.zillow.com/local-info/CA-Salinas/r\\_54288/](http://www.zillow.com/local-info/CA-Salinas/r_54288/) (last visited June 30, 2009)(listing 585,000 as the average home price in January 2006).

an interest rate of 6.5%, their total monthly payment is \$4300,<sup>32</sup> which is just under 31% of their gross monthly income, and within the payment-to-income ratio considered “affordable” by most lenders. However, after paying for taxes, health insurance, student loans, childcare, automobiles, food, and other necessities, Sam and Chris do well to break even each month. At the time they bought their home, they were not overly concerned about this - as they saw their mortgage payment itself as an investment in their own and their children’s futures.

Unfortunately for Sam and Chris, the housing market began to collapse in 2007. Though they still owe about \$560,000 on their home,<sup>33</sup> it is now only worth \$187,000.<sup>34</sup> A similar house around the corner from Sam and Chris recently listed for \$179,000, which, with a modest 5% down, would translate to a total monthly payment of less than \$1200 per month – as compared to the \$4300 that they currently pay. They could rent a similar house in the neighborhood for about \$1000.<sup>35</sup>

Assuming they intend to stay in their home ten years, Sam and Chris would save approximately \$340,000 by walking away, including a monthly savings of at least \$1700 on rent versus mortgage payments, even after factoring in the mortgage interest tax reduction. The financial gain for Sam and Chris from walking away would be even more substantial if they took their monthly savings and put it into an investment account. If they stay in their home on the other hand, it will take Sam and Chris over 60 years just to recover their equity – assuming, of course, that they live that long, the market in Salinas has indeed hit bottom, and their home appreciates at the historical appreciation rate of 3.5%.<sup>36</sup>

Millions of homeowners who bought homes in the last five years are in similar situations to Sam and Chris, particularly in the hardest hit states of California, Florida, Nevada, and Arizona. For example, a homeowner who bought an average home in Miami at

---

<sup>32</sup> This calculation assumes a loan of \$585,000 at 6.5%, mortgage insurance of \$233, taxes \$250, and homeowners insurance of \$120. *Id.*

<sup>33</sup> Calculation based upon amortization at 42 months, with approximately \$650 going toward principle each month. The remaining \$3700 of the payment is interest, taxes and insurance.

<sup>34</sup> This price is based upon Zillow data for Salinas, CA. *Zillow, Salinas Overview*, [http://www.zillow.com/local-info/CA-Salinas/r\\_54288/](http://www.zillow.com/local-info/CA-Salinas/r_54288/) (last visited June 30, 2009)(indicating that the average home reached \$585,000 in 2006 and that the average home is now worth \$187,000).

<sup>35</sup> Based upon prices of homes currently listed for sale on Zillow in Salinas, CA, *id.*, and average rent identified in HYE JIN RHO, ET. AL., *supra* note 25

<sup>36</sup> HYE JIN RHO ET AL. *supra* note 25 (indicating that historical appreciation rates for home prices have been between 3% and 4%.)

the peak would have paid around \$355,400.<sup>37</sup> That home would now be worth only \$198,000<sup>38</sup> and, assuming a 5% down payment, the homeowner would have approximately \$132,000 in negative equity.<sup>39</sup> He could save approximately \$116,000 by walking away and renting a comparable home.<sup>40</sup> Or, he could stay and take 20 years just to recover lost equity – all the while throwing away \$1300 a month in net savings that he could invest elsewhere. The advantage of walking is even starker for the large percentage of individuals who bought more-expensive-than-average homes in the Miami area – or in any bubble market for that matter<sup>41</sup> - in the last five years. Millions of U.S. homeowners could save hundreds of thousands of dollars by strategically defaulting on their mortgages.<sup>42</sup>

Homeowners should be walking away in droves. But they aren't. And it's not because the financial costs of foreclosure outweigh the benefits. To be sure, foreclosure comes with costs, including a significant negative impact on one's credit rating.<sup>43</sup> But assuming one had otherwise good credit, and continues to meet other credit obligations, one can have a good credit rating again – meaning above 660 - within two years after a foreclosure.<sup>44</sup>

---

<sup>37</sup> Zillow, Miami Home Prices, Home Values, and Property Values, [http://www.zillow.com/local-info/FL-Miami-home-value/r\\_12700/](http://www.zillow.com/local-info/FL-Miami-home-value/r_12700/) (last visited Sep. 7, 2009).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* (assumes 5% down with an interest rate at national average of 6.5% for June 2007).

<sup>40</sup> Assumes monthly interest of \$1824, mortgage insurance of \$219, taxes of \$500, and homeowners insurance of \$100, with \$329,830 balance remaining on the mortgage. The estimate for mortgage insurance is from [http://www.goodmortgage.com/Calc\\_PMI.htm](http://www.goodmortgage.com/Calc_PMI.htm).

<sup>41</sup> See HYE JIN RHO, ET. AL., *supra* note 25, at 17 (listing “bubble markets”).

<sup>42</sup> Average national numbers show that home prices have declined 25% nationally from \$240,000 at the peak to \$184,000 in June of 2009. See Zillow, Real Estate Market Reports, <http://www.zillow.com/local-info/#metric=mt%3D34%26dt%3D1%26tp%3D5%26rt%3D14%26r%3D102001> (last visited Oct. 9, 2009).

<sup>43</sup> Just how much impact a foreclosure has on one's credit is unclear because the Fair-Isaac Company will not share this information. But generally one can expect a 100 to 150 point hit to his or her credit as a result of a foreclosure, and additional hits for each late payment – which are generally reported separately from the foreclosure itself. See *How Foreclosures, Short Sales, and Bankruptcies Affect Your Credit Score*, AMERICAN BANKING NEWS, Oct. 8, 2009, <http://www.articlesbase.com/real-estate-articles/how-does-foreclosure-impact-your-credit-report-234979.html>. The total hit from late payments and a foreclosure could be as much as 300 to 400 points. Additionally, one must wait seven years before the foreclosure disappears from one's credit report entirely. *Id.*

<sup>44</sup> See Marilyn Kennedy Melia, Life After Foreclosure, Bankrate.com, <http://www.bankrate.com/finance/mortgages/life-after-foreclosure-2.aspx> (last visited Oct. 9, 2009) (noting, “If a foreclosure is an isolated event on an

Additionally, in as little as three years, one can qualify for a federally-insured FHA loan to purchase another home.<sup>45</sup>

While the actual financial cost of having a poor credit score for a few years may be hard to quantify, it is not likely to be significant for most individuals – especially not when compared to the savings from walking away from a seriously underwater mortgage. While a good credit score might save an average person ten of thousands of dollars over the course of a *lifetime*, a few years of poor credit shouldn't cost more than few thousand dollars. Moreover, one who plans to strategically default can take steps to minimize even this marginal cost. For example, one could purchase a new vehicle, secure a new home to rent, or even purchase a new house before beginning the process of defaulting on one's mortgage. Most individuals should be able to plan in advance for a few years of limited credit.

There are, of course, costs to foreclosure other than temporarily poor credit. These include moving costs and possible transportation costs if one is required to live further from work or school. But again, these costs are minimal when compared to the savings of shedding a home that is hundreds of thousands of dollars underwater. The most significant financial risk from a foreclosure is the risk of a deficiency judgment or, in the alternative, tax liability for the unsatisfied portion of one's loan upon foreclosure. But even these potential costs are significantly less than one might expect. First, a number of states – including many with the biggest declines in home values - are non-recourse states, meaning that lenders may not pursue homeowners for a deficiency judgment if the home was their primary residence. Second, even in recourse states, lenders rarely pursue borrowers for deficiency judgments unless they have special reason to suspect

---

otherwise good credit record, consumers may be able to rehabilitate their record and garner better loans and card rates in 24 months"); *see also* CreditScoreQuick.com, Revive Credit Report after Foreclosure, <http://www.creditscorequick.com/2008/03/revive-credit-report-after-foreclosure.html> (site last visited Sept. 26, 2009) ("Your credit report might recover quickly as long as you have other good standing credit reporting on your credit report.")

<sup>45</sup> CreditScoreQuick.com, Mortgages Fixes and Your Credit Score, <http://www.creditscorequick.com/2009/08/mortgage-fixes-and-your-credit-scores.html> (site last visited September 26, 2009). Because banks are often much more willing to negotiate a short sale once it becomes clear that a homeowner intends to default, strategically default need not result, and often does not result, in a foreclosure. The negative effect of a short sale one's credit is significantly less than a foreclosure and depends on the negotiated agreement between the borrower and the lender. For example, if the lender agrees to report the loan as "paid," there is no negative impact, whereas if the lender reports it "settled," the negative impact can be quite significant. *Id.*

the borrower has means to pay it.<sup>46</sup> This is particularly true to the extent that the home is in a state where lenders are overwhelmed with foreclosures.<sup>47</sup> Third, tax regulations have recently changed to waive taxes on the unpaid portion of a mortgage upon foreclosure, which was previously classified as income to the borrower if the lender reported it as such.<sup>48</sup>

In short, the financial costs of foreclosure, while not insignificant, are minimal compared to the financial benefit of strategic default – particularly for seriously underwater homeowners.<sup>49</sup> For many, default is the “in the money” option by any objective measure. Yet most seriously underwater homeowners aren’t walking away - even as they sink deeper into negative equity.

#### IV. Explaining Homeowner Choices

It might be tempting to label such underwater homeowners “woodheads,” a term sometimes applied in economic literature to individuals who choose not to act in their own self-interest.<sup>50</sup> But labeling such behavior irrational does little to explain its existence. One possible explanation is that the low rate of strategic default is not the result of irrational decision-making at all, but rather the result of utility maximizing calculations by homeowners. In other words, it could be that underwater homeowners generally understand that they could save hundreds of thousands of dollars by defaulting on their mortgages, but they simply value their homes (in which they may have “made large financial, emotional,

---

<sup>46</sup> See e.g., Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073 (2009) (finding that even in recourse states, deficiency actions are often not cost-effective for the lender, thus turning recourse loans into de-facto non-recourse loans)

<sup>47</sup> See Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. TIMES, June 29, 2009, <http://www.nytimes.com/2009/06/29/business/29loanmod.html>

<sup>48</sup> The Mortgage Debt Relief Act of 2007 excludes income from the discharge of debt on principal residences. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief. This provision applies to debt forgiven in calendar years 2007 through 2012.

<sup>49</sup> As discussed above, a significant portion of homeowners fall into the “seriously underwater” category. For example, 47% percent of homeowners in Nevada had negative equity exceeding 25% of their home’s value, as did 30% of homeowners in Florida, 29% in Arizona, and 25% in California. First American CoreLogic, *Negative Equity Report* (Aug. 13, 2009). Given the high median home prices at the peak within these markets, a large percentage of these homeowners are underwater by hundreds of thousands of dollars.

<sup>50</sup> See, e.g., Deng & Quigley, *supra* note **Error! Bookmark not defined.**, at 3-4

and psychological investments”) more than the market does.<sup>51</sup> The “market value” of a home may be, for example, \$198,000, but it could be worth \$355,000 to the homeowner – indeed why else would they pay that much for it in the first place.<sup>52</sup> Additionally, homeowners as a class may be risk adverse, meaning that they value the security of their good credit and of knowing they will not suffer a deficiency judgment or a large tax bill (even if the risk of either is low) over the money that they could save by defaulting. Finally, homeowners as a class may value not having to move more than they value the thousands they could save by walking away and renting.<sup>53</sup> As one economist has argued, “The so-called underexercise of the default option, therefore, is actually rational behavior without transaction costs...”<sup>54</sup>

This explanation naïvely – or deliberately - ignores much of the cognitive sciences tell us about how humans actually make decisions. As behavioral economists understand, humans make decisions in ways that are less than fully rational – but are understandable given the ways that humans (mis)perceive and (mis)process information.<sup>55</sup> On a basic level, most humans have difficulty doing mathematical calculations and are easily overwhelmed, for example, by the variety of factors that one must consider in deciding the financial benefits and costs of strategically defaulting.<sup>56</sup> Humans are also susceptible to what behavioral economists call the status quo bias – or the tendency to keep one’s

---

<sup>51</sup> See Ross, *infra* note 70, at 9 (noting “individuals had made large financial, emotional, and psychological investments in their home.”)

<sup>52</sup> See Paul Krugman, *How Did Economists Get it so Wrong*, N.Y. TIMES, September 2, 2009 (discussing a general belief among neoclassical economists “that bubbles just don’t happen” and quoting Eugene Fama, “the father of the efficient-market hypothesis,” as follows: “the word ‘bubble’ drives me nuts... Housing markets are less liquid, but people are very careful when they buy houses. It’s typically the biggest investment they’re going to make, so they look around very carefully and they compare prices. The bidding process is very detailed.”).

<sup>53</sup> For support of such a suggestion, see Ross, *infra* note 70, at 10 (discussing the ontological security of homeownership, arguing that “the home offer[s] individuals a sense of order, continuity, and place or physical belonging.”)

<sup>54</sup> Kerry D. Vandell, *Handing Over the Keys: A Perspective on Mortgage Default Research*, 21 J. AM. REAL ESTATE & URBAN ECON. ASS’N 211, 236 (1993).

<sup>55</sup> See e.g., Bar-Gill, *supra* note 46, at 40 (discussing the affects of human limitations on attention, memory, and processing ability which lead to less than rational decisions, such as simply ignoring critical details in mortgage contracts, when confronted with complex calculations).

<sup>56</sup> See e.g., Ubel, *supra* note 3 (positing that human nature when confronted with financial decisions involving detailed mathematics is to disregard legitimate financial fears and follow the advice of others, such as real estate agents).

head in the sand.<sup>57</sup> This bias means that even those humans who could do complex calculations if they wanted to, usually don't. Moreover, humans suffer from other cognitive biases such as myopia, or the tendency to overvalue up-front cost and undervalue long-term gain.<sup>58</sup> Thus, most underwater homeowners may fail to cognitively grasp the full benefit of strategic default.

Additionally, like all human beings, homeowners suffer from selective perception,<sup>59</sup> which causes them to fail to see evidence – such as actual prices of sold homes in their neighborhood – that would suggest a steep fall in their home's value.<sup>60</sup> Instead, they see contrary indicators such as the list prices of overpriced homes in their neighborhood, which taken out of context suggest that prices have not fallen significantly. Selective perception also causes homeowners to fail to attend to estimates on websites such Zillow.com or fhfa.gov that show their home's declining value and to discount media reports of steep price declines as somehow inapplicable to their unique home, or their special neighborhood.<sup>61</sup> Relatedly, homeowners tend toward optimistic overconfidence,<sup>62</sup> – believing, for example, that home prices will bounce back in a few years and that their homes will soon be worth more than they paid.<sup>63</sup> Indeed, selective perception may have caused many homebuyers to ignore signs of the impending housing market collapse in the first place - and optimistic overconfidence may have caused many homeowners to take out interest-only ARMs in the misplaced belief that they would have better salaries

---

<sup>57</sup> William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988); see also Mario J. Rizzo & Douglas Glen Whitman, *Little Brother is Watching You: New Paternalism on the Slippery Slopes*, 51 ARIZ. L. REV. 685, 686 (2009).

<sup>58</sup> See R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23 REV. ECON. STUD. 165 (1955-56); Lester C. Thurow, *Cash Versus In-Kind Transfers*, 64 AM. ECON. REV. 190 (1974); see also Barak Y. Orbach, *Unwelcome Benefits: Why Welfare Beneficiaries Reject Government Aid*, 24 LAW & INEQ. 107, 122 (2006).

<sup>59</sup> Ubel, *supra* note 3 (labeling the human susceptibility to selective perception as “unrealistic optimism”).

<sup>60</sup> See *Housing Over-Confidence*, INVESTORS CHRON., Apr. 27, 2009 (noting, “On hearing that a neighbour's house has sold for a low price, our reaction is often: ‘But our house is much more presentable than theirs.’ Everyone thinks they are Sarah Beeny. But they are not.”)

<sup>61</sup> *Id.* (discussing the fact that, due to optimistic overconfidence, sellers generally fail to adequately take price declines into account when setting list prices.”)

<sup>62</sup> Ubel, *supra* note 3 (noting that due to “unrealistic optimism” homeowners over-estimated the future growth of their salaries and home values).

<sup>63</sup> An analogy here would be the reluctance of many investors to sell a share that drops significantly in value after they bought it and wait in hopes that the share will climb back up to the initial purchase price – even though there may be little hope of it doing so.

in a few years, or would refinance as their home's value grew exponentially.<sup>64</sup>

There is certainly much in this behavioral economic account that helps explain the choices of underwater homeowners. Many homeowners do tend to overvalue their homes, particularly if they bought them during booms.<sup>65</sup> Many homeowners also have their head in the sand, preferring to focus on things that they believe they can control rather than things that they believe they cannot.<sup>66</sup>

On the other hand, labeling the status quo bias, selective perception, and optimistic overconfidence as “cognitive biases,” doesn't account for the way in which emotions unconsciously color the perceptions of individuals who want, or need, to believe something – including, for example, that their house is worth what they paid.<sup>67</sup> As a large body of work in the neurosciences has revealed, much of what passes for cognitive bias is actually emotional bias, reached with no cognitive process whatsoever.<sup>68</sup>

---

<sup>64</sup> See *Housing Over-Confidence*, *supra* note 59 (discussing distorting effect on prices of the irrational belief that house prices would continue to rise.)

<sup>65</sup> See *Id.* (noting that: “The average person over-estimates the price of their house by between five and ten per cent. But there's variation around this average. Whereas people who bought in recessions tend to value their houses accurately, those who bought in booms are even more over-optimistic, overvaluing their properties by up to 20 per cent.” And further explaining that: “There are strong cognitive biases causing this - and not just plain wishful thinking. One is the availability heuristic effect. If your biggest exposure to housing market economics came when you bought during a boom - and of course, many more people buy in booms than slumps - rapid house price appreciation will loom large in your mind. This will cause you to over-estimate its size and frequency, and so over-estimate your own house price.”)

<sup>66</sup> If one accepts that homeowner decisions are the result of cognitive biases, the solution to helping homeowners make better decisions – should policy makers or others actually wish to encourage rational economic behavior by underwater homeowners – is to help homeowners think better. This means providing better information, helping homeowners calculate the benefits and costs of default, and pointing out the cognitive biases that cloud their thinking. Under this line of thinking, homeowners just need a little help in order to behave more rationally.

<sup>67</sup> See Christopher Merkle, *Emotion and Finance - An Interdisciplinary Approach to the Impact of Emotions on Financial Decision Making* 14-15 (Working Paper, Feb. 28, 2007), available at <http://ssrn.com/abstract=1097131> (“feelings act as a selective attentional filter for incoming stimuli. The strong immediate experience of emotion may lead to a crowding out of other goals. Secondly emotion influences the retrieval of information and knowledge from memory.”). See also Zajonc at 157.

<sup>68</sup> See e.g., Ralph D. Ellis & Natika Newton, *Introduction* (summarizing collected papers addressing influence of emotion on perception), in *CONSCIOUSNESS & EMOTION: AGENCY, CONSCIOUS CHOICE, AND SELECTIVE PERCEPTION* ix, x-xi (Ralph D. Ellis & Natika Newton eds., 2005); R.B. Zajonc, *Feeling and Thinking: Preferences Need No Inferences*, 35 *AM. PSYCHOLOGIST* 151, 155 (1980); John A. Bargh and Tanya L. Chartrand, *The Unbearable*

In other words, when one is consciously or unconsciously motivated to reach a certain conclusion, the brain's emotion systems focus awareness on information that is congruent with one's emotional need and directs the conscious to ignore, reinterpret, or discount incongruent information.<sup>69</sup> As such, if a homeowner is not emotionally receptive to the idea that their home is worth thousands less than they paid, it may be next-to-impossible to convince him that he is underwater in the first place, much less that it will take 20 years just to recover lost equity.<sup>70</sup> Similarly, if a homeowner places great emotional stock in his credit score, it may be futile to try to convince him that a few years of a poor credit is not a big deal. Indeed, trying to persuade the homeowner that he is wrong is likely to make him stick even more firmly to his prior beliefs.<sup>71</sup>

Thus, if one is to understand how homeowners think, one must understand how they feel. Most mortgage default risk modeling fundamentally fails to appreciate this point and more generally does not account for the primacy of emotion in driving human behavior and decision-making. This may not matter if the goal is to merely describe or model observable human behavior, but it does matter to the extent that policymakers and others are interested in encouraging individuals to make different choices –

---

*Automaticity of Being*, 54 AM. PSYCHOLOGIST 7 (1999). See also, David P. Redlawsk, *Motivated Reasoning, Affect, and the Role of Memory in Voter Decision Making*, in FEELING POLITICS: EMOTION IN POLITICAL INFORMATION PROCESSING (David P. Redlawsk ed., 2006); (noting that “Emotion “may indeed, be the primary vehicle implicated in motivated reasoning, leading to selective attention, information distortions, and recall biases.”); Merkle, *supra* note 64 (“Attention is focused on aspects of a situation that are consistent with the prevailing emotion, what may result in different estimations of probabilities for certain events or a different rating of an alternative’s global attractiveness.”); Terry Maroney, *Law and Emotion: A Proposed Taxonomy of an Emerging Field*, 30 (2) LAW AND HUMAN BEHAVIOR 119 (2006) (noting that, “First, emotion can influence both which stimuli are perceived and how they are perceived. This is first seen through the mechanism of attention. Because emotionally salient stimuli tend to be the ones of greatest significance to one's thriving, they will be attended to disproportionately.”).

<sup>69</sup> See Milton Lodge, Charles Taber & Christopher Weber, *First Steps Toward a Dual-Process Accessibility Model of Political Beliefs, Attitudes, and Behavior*, in FEELING POLITICS, *supra* note 66.

<sup>70</sup> Lauren Ross, *The Internal Costs of Foreclosure* 38, August 31, 2009 (unpublished thesis) (on file with author) (noting that “[m]any individuals are reluctant to acknowledge that the housing and mortgage markets have significantly changed and are no longer wholly sustainable or lucrative investments.”).

<sup>71</sup> David P. Redlawsk, *Feeling Politics: New Research into Emotion and Politics*, in FEELING POLITICS, *supra* note [x], at 1 (explaining that individuals often end up feeling stronger than they did before being confronted with information that would have been expected, under rational models of belief formation, to cause them to reassess their existing beliefs).

or to continue to make the same choices for that matter. In most studies of homeowner decision-making, however, emotions are treated as an x-factor to be calculated *around* in figuring out how other varying factors affect individual choice and market behavior.<sup>72</sup> Emotion is rarely considered in and of itself as a primary factor motivating both people and markets. For example, default risk analysts have studied the relationships between initial loan-to-value and mortgage default,<sup>73</sup> current equity and mortgage default, affordability and mortgage default,<sup>74</sup> credit scores and mortgage default,<sup>75</sup> geography and mortgage default,<sup>76</sup> and unemployment and mortgage default<sup>77</sup> – to name a few. But researchers have shown little interest in the relationship between guilt and mortgage default.<sup>78</sup> Nor have they shown any interest in the relationship between fear and mortgage default.

The neglect of emotion is particularly intriguing given the recent work of Luigi Guiso, Paola Sapienza, and Luigi Zingales, which found that 81% of homeowners believe that it is immoral to default on a mortgage, and that homeowners who hold this attitude are 77% less likely to declare their intention to default than those who do not.<sup>79</sup> Indeed, once the equity shortfall exceeds 10% of a home's value, the study found that “moral and social considerations” are the “most important variables predicting

---

<sup>72</sup> See Vandell, *infra* note 165, at 236 (pricing models “all assumed ruthless default whenever the value of the mortgage dropped below the value of the property” and ignored “psychological costs.”); and See Foote, et. al., *supra* note 14 at 5 (explaining that in their default prediction model the probability of default, guilt, shame, and reduced access to future credit were calculated around: “We assume that the decision to default costs the borrower some amount  $\Lambda$  next period, which can be interpreted as some combination of guilt, shame, and reduced access to future credit.”)

<sup>73</sup> Yongheng Deng, John M. Quigley, & Robert Van Order, *Mortgage Terminations, Heterogeneity and the Exercise of Mortgage Options*, *ECONOMETRICA* 275 (2000) (showing that higher default risk is related to higher initial LTV's).

<sup>74</sup> See Foote, et. al., *supra* note 14 at 3-13.

<sup>75</sup> Satjajit Chatterjee, Dean Corbai, & José Victor Ríos-Rull, *Credit Scoring and Competitive Pricing of Default Risk* (unpublished and incomplete, Jan. 2007), *available at* <http://pier.econ.upenn.edu/Events/scorevictor.pdf>.

<sup>76</sup> Deng, Quigley, & Van Order, *supra* note 71 at 23.

<sup>77</sup> *Id.* at 17 (finding that trigger events, such as unemployment and divorce have significant impact on homeowners' exercise of the default option).

<sup>78</sup> While it may seem obvious that one who feels guilty about the idea of defaulting will be less likely to do so, it is equally obvious that those with high loan-to-value ratios, the unemployed, and individuals with low credit scores will be more likely to default. But economists study these things anyway in order to determine how much they matter and how predictive they are of mortgage default. Such information is used by economists to assist lenders in assessing risk and pricing mortgages, but it also informs public policy by purporting to illuminate the most efficient ways to reduce foreclosures.

<sup>79</sup> Guiso et al., *supra* note 11, at 21.

strategic default.”<sup>80</sup> So strong are these variables, in fact, that only 17% of homeowners indicated that they would default if the equity shortfall reached 50%.<sup>81</sup> On the other hand, the study found that people who know someone who has strategically defaulted are 82% more likely to declare their intention to do so.<sup>82</sup> The authors thus caution that “a policy aimed at helping people in arrears with their mortgage could have devastating effects on the incentives to strategically default of people who can afford to pay their mortgage if it is perceived to bail out people unjustly and thus undermine the moral commitment to pay.”<sup>83</sup>

While the study sheds important light on the role of social and moral constraints in the default decision, its conclusion also highlights the problem with crafting public policy from studies that do not try to understand *why* people act the way that they do. Perhaps the authors are right--perhaps people will respond to loan modification programs for those who can no longer afford their mortgages by defaulting on their own mortgages--but there is no evidence to suggest that this is the case. One might just as easily assert that the failure of banks to modify loans for individuals in need, while banks themselves have been bailed out by the federal government, will cause individuals to conclude that they should forget about morals and just look out for their own self-interests.<sup>84</sup> In order to know whether either of these assertions is true, one needs to understand how moral beliefs and attitudes are formed, and one needs to understand how humans make decisions. And, as evidence from the cognitive sciences convincingly demonstrates, emotion is primary to both.<sup>85</sup>

The Guiso, Sapienza, and Zingales article does however confirm something that policy makers and lenders already know

---

<sup>80</sup> *Id.* at 21-22.

<sup>81</sup> *Id.* at 15.

<sup>82</sup> *Id.* at 6.

<sup>83</sup> *Id.* at 3. Indeed, one thrust of the paper is that the Obama administration’s plan to encourage modification of loans to make them more affordable is misguided - and likely to backfire. *Id.* at 21.

<sup>84</sup> For an example of one individual who feels this way, see the web posting of L. Serbanescu at Economist.com, available at [http://www.economist.com/businessfinance/displayStory.cfm?story\\_id=13905502&mode=comment&#commentStartPosition](http://www.economist.com/businessfinance/displayStory.cfm?story_id=13905502&mode=comment&#commentStartPosition) (writing that “[t]he financial system created the house market bubble, putting everyone that wanted a house in the uncomfortable position of paying inflated prices. The financial establishment made tons of money in the process....Now that ditching a mortgage makes economic sense for a homeowner, The Economist discovers that such behavior is immoral...Why should anyone be morally obliged to continue to pay them at a loss?”).

<sup>85</sup> R.B. Zajonc, *Feeling and Thinking: Preferences Need No Inferences*, 35 AM. PSYCHOLOGIST 151, 155 (1980); John A. Bargh and Tanya L. Chartrand, *The Unbearable Automaticity of Being*, 54 AM. PSYCHOLOGIST 7 (1999).

and use to their advantage: people are less likely to default if doing so will make them feel like immoral or irresponsible persons – and are especially unlikely to default if they believe others will think of them as immoral or irresponsible persons.<sup>86</sup> Guilt and shame are powerful motivators,<sup>87</sup> and there is no doubt that many people who have faced foreclosure feel a great deal of both.<sup>88</sup>

As Linda, a single mom in Tampa who asked that her last name not be used, explained, "As a mom, I feel like I let my children down... It's a terrible embarrassment, and it's humiliating."<sup>89</sup> Linda is not alone: a recent qualitative sociological study of the internal costs of foreclosure found that feelings of personal failure, shame, and embarrassment dominated the accounts of individuals who had lost their homes to foreclosure.<sup>90</sup> Moreover, such feelings predominated even when individuals were not at fault for their predicament, but were victims of the declining economy and/or unethical practices by mortgage brokers.<sup>91</sup> And,

---

<sup>86</sup> Guiso et al., *supra* note 11, at 8 (stating that “[m]oral considerations, if widespread, may strongly mitigate the likelihood that American households will default on their mortgage”). Research in social psychology has shown that humans invest significant emotional stake in “face” – or their “claimed identity as a competent, intelligent, or moral persons” - and will go to great lengths to avoid actions which publically threaten this identity. See Holley S. Hodgins & Elizabeth Liebeskind, *Apology Versus Defense: Antecedents and Consequences*, 39 J. EXPERIMENTAL SOC. PSYCHOL. 297, 297 (2003).

<sup>87</sup> See Danielle Einstein and Kevin Lanning, *Shame, Guilt, Ego Development, and the five-factor model of personality*, 66 JOURNAL OF PERSONALITY 555 (1998) (explaining that guilt and shame are negative affective states which act as moral voices guiding social activity of individuals).

<sup>88</sup> See Ross, *supra* note 68 (“The notion of guilt ascription was also central to these findings. Although many individuals recounted the exact ways in which they were “mised” in their loan negotiations, they often returned to the idea of being personally responsible for their actions.”).

<sup>89</sup> Judi Hasson, *Homeowners Who Just Walk Away*, MSN MONEY, <http://articles.moneycentral.msn.com/Banking/HomeFinancing/HomeownersWhoJustWalkAway.aspx> (last visited Oct. 9, 2009).

<sup>90</sup> See Ross, *supra* note 68, at 37

<sup>91</sup> See *id.* at 35. One woman in the study described her sense of “utmost responsibility to make her monthly payments on time” as follows:

I made a commitment to pay my loan and I want to pay my loan. I'm a hard working person and I want to make good on my loan, but there's no way I possibly can in the situation the economy's in right now.

Others expressed concern over being perceived as “irresponsible citizens’ or “burdens on society:”

And um so I'm just, I'm kind of interested in the public perception. You know I don't want to be a burden on the rest of society because I'm not paying my mortgage. Now there's

as further evidence of the shame and guilt felt by those who experience foreclosure, large damage awards for humiliation are common features of successful suits against lenders for wrongful foreclosure.<sup>92</sup>

While no study to date has sought to quantify the role of the desire to avoid guilt and shame in underwater homeowners' decisions not to strategically default, more general studies on the role of guilt and shame in motivating human behavior suggest a significant impact.<sup>93</sup> The desire to avoid guilt and shame cannot,

---

this big giant bailout and I'm involved in that. You know, my mortgage was one of the mortgages not being paid.

<sup>92</sup> See, e.g., *Levine v. First Nat. Bank of Commerce*, 917 So.2d 1235, 05-106 (La.App. 5 Cir. 2005) (holding "evidence was sufficient to support award to mortgagor of \$150,000 for humiliation and embarrassment and \$150,000 for mental anguish); *Clark v. West*, 395 S.E.2d 884 (Ga.App., 1990) (holding "[m]ortgagor's obtaining cancellation of foreclosure sale in equitable action did not bar her from pursuing separate claim of damages for humiliation and emotional distress for the alleged intentional, wrongful foreclosure by mortgagees); *Carter v. Countrywide Home Loans*, 2009 WL 1010851 (E.D.Va. 2009) (allowing claims for "humiliation and damage to reputation" due to wrongful foreclosure under the Real Estate Settlement Procedures Act ("RESPA"), 12 U.S.C. § 2601 et seq., and the Fair Debt Collection Practices Act ("FDCPA"), 15 U.S.C. § 1692 et seq.); *Mason v. Chase Bank of Texas, N.A.*, 2008 WL 3412212 (Tex.App.-Dallas 2008) (claim for humiliation from attempted foreclosure); *Brannon v. Bridge Capital Corp.*, 2008 WL 2225791 (M.D.Ala., 2008) (discussing plaintiff claim that "foreclosure publishings caused him embarrassment and humiliation); *Lee v. Javitch, Block & Rathbone, LLP*, 2008 WL 1886178 (S.D.Ohio 2008) (humiliation from wrongful foreclosure recoverable under the FDCPA); *Cushing & Dolan, PC v. National Lenders, Inc.*, 2004 WL 2712208 (Mass.Super., 2004) (claim for "humiliation" due to "public notices of foreclosure on their home and the inspection of their home by potential buyers, lawyers, and auctioneers."); *Volk v. Wisconsin Mortg. Assur. Co.*, 474 N.W.2d 40 (N.D. 1991) (claiming damage to plaintiffs "personal reputation, credit rating, financial reputation, unfavorable publicity, embarrassment, humiliation, and ridicule caused by the foreclosure action."); and *Union Federal Sav. Bank v. Hale*, 1993 WL 488399 (Ohio App. 9 Dist. 1993) (defendant in foreclosure action averring that "as a result of Plaintiff's wrongful refusal to accept the aforementioned mortgage payments, I have suffered damage to my credit rating and reputation; emotional distress, anxiety, embarrassment, humiliation and worry....").

<sup>93</sup> See e.g., CARROLL E. IZARD, *HUMAN EMOTIONS*, (New York: Plenum 1977)(explaining that guilt is the primary motivational factor in a mature conscience); Dwight Merunka , et. al., *Modeling and Measuring the Impact of Fear, Guilt and Shame Appeals on Persuasion for Health Communication: a Study of Anti-Alcohol Messages*, Working paper (2009)(finding that "Shame motives social behavior and leads to conformity to social norms."); and Damien Arthur and Pascale Quester, *Who's Afraid of that Ad? Applying Segmentation to the Protection Motivation Mode*, 21 PSYCHOLOGY AND MARKETING 671 (2004) (demonstrating the importance of fear, guilt, and shame in determining behavior).

however, completely explain the reluctance of homeowners to default. Indeed, the Guiso, Sapienza, and Zingales study found that only 41% of individuals who no moral issue with strategic default would strategically default at \$100,000 in negative equity.<sup>94</sup> The question is thus: what keeps the other 59% from walking? Guiso, Sapienza, and Zingales theorize that even amoral people may be deterred from defaulting by the social stigma that comes with foreclosure.<sup>95</sup> They are probably right – up to a point. But their study did not actually ask these “amoral” individuals what keeps them from walking. At some point – if not \$100,000 then \$200,000 (where 41% of the “amoral” individuals still would not walk)<sup>96</sup> - social stigma alone becomes an unconvincing explanation.

Moreover, foreclosure rates are considerably lower than would be suggested by the Guiso, Sapienza, and Zingales study, as the percentage of people who actually default is much lower than the percentage that indicated they would default in the survey, moral qualms or not. For example, the study found that 26% of individuals would default at \$100,000 in negative equity and 41% would do so at \$200,000.<sup>97</sup> But given the number of homeowners that are significantly underwater, one would expect foreclosure rates should be higher if this were the case.

The voices of those who have actually faced foreclosure suggest another powerful emotion that may be keeping homeowners from defaulting: fear. Indeed, the term commonly used to describe foreclosure by those who face it is “terrifying.”<sup>98</sup> As one commentator on foreclosure has noted, “foreclosure is that terrifying word no homeowner ever wants to hear, let alone experience.”<sup>99</sup> People not only fear losing their homes, but fear having ruined credit for life, not be able to find a decent place to live, to buy a car, to get a credit card, to get insurance, to ever buy a house, or even get a job. Foreclosure is seen as the end of life as

---

<sup>94</sup> Guiso et al., *supra* note 11, at 10.

<sup>95</sup> *Id.* at 8.

<sup>96</sup> *Id.* at 17.

<sup>97</sup> *Id.* at 17.

<sup>98</sup> John Leland, *Facing Default, Some Walk Out on New Homes*, N.Y. TIMES, Feb. 29, 2008 (homeowner reporting being “terrified” by foreclosure); *Las Vegas Military Wife Fights to Save Home*, LAS VEGAS NOW <http://www.lasvegasnow.com/Global/story.asp?S=10965954> (describing “terrifying” fight to save home); and Chris Isidore, *Homes in Foreclosure Top 1 Million*, CNNMONEY, June 5, 2008, <http://money.cnn.com/2008/06/05/news/economy/foreclosure/index.htm?postversion=2008060510> (describing foreclosure as terrifying).

<sup>99</sup> See Jenny Greenleaf, About Foreclosure Law, eHow, [http://www.ehow.com/about\\_4571547\\_foreclosure-law.html](http://www.ehow.com/about_4571547_foreclosure-law.html) (last visited Oct. 9, 2009) (noting, “Foreclosure is that terrifying word no homeowner ever wants to hear, let alone experience”).

one knows it: financial suicide to be avoided at all costs.<sup>100</sup> In short, fear – like shame and guilt - is a powerful motivator in homeowner decisions not to default.<sup>101</sup>

Further empirical study is necessary to qualify the statistical significance of shame, guilt, and fear in homeowner decisions to strategic default. But all three play a critical role in motivating human behavior and deserve further academic study in the mortgage default context.<sup>102</sup> Academics and non-academics alike, however, intuitively understand the power of these emotions to control human behavior. As such, those who benefit from underwater homeowner decisions not to default have not waited for statistical proof of the efficacy of those emotions to cultivate them.<sup>103</sup>

## V. The Social Control of the Housing Crisis

A concern repeatedly voiced by policy makers, economists, and the media is that the “social pressure not to default will weaken” to the point homeowners will begin to walk in droves.<sup>104</sup> Of particular concern is the contagion effect, the notion that once a

---

<sup>100</sup> Of course, to argue that homeowner decisions not to default are motivated by fear is not to suggest that cognitive biases play no role. The two are not mutually exclusive – but are mutually reinforcing. Much homeowner fear is driven by the misperception or overestimation of the future costs associated with foreclosure – and this fear in turn leads to further selective perception and/or wishful thinking about the probability of housing prices returning to previous levels.

<sup>101</sup> See e.g., Damien Arthur and Pascale Quester, 2004, *Who's Afraid of that Ad? Applying Segmentation to the Protection Motivation Mode*, 21 *Psychology and Marketing* 671 (2004) (confirming the positive relationship between fear and persuasion); Michael S. LaTour and Herbert J. Rotfeld, *There are Threats and (May be) Fear-Caused Arousal: Theory and Confusions of Appeals to Fear and Fear Arousal Itself*, 26 *JOURNAL OF ADVERTISING* 45(1997)(confirming that fear motivates behavior); Irving L. Janis and Seymour Freshbach, *Effects of Fear-Arousing Communications* 48 *JOURNAL OF ABNORMAL AND SOCIAL PSYCHOLOGY* 78 (1953) (finding that fear appeals influence attitudes and behavior).

<sup>102</sup> For studies of the role of guilt, shame and fear in motivating behavior in other contexts, see e.g., Damien Arthur and Pascale Quester, *supra* note 97 (demonstrating the power of negative emotions of fear, guilt, and shame in marketing) and Ken Chapman, *Fear Appeal Research: Perspectives and Application*, 3 *AMERICAN MARKETING ASSOCIATION SUMMER EDUCATOR'S CONFERENCE PROCEEDINGS* 1 (1992) (finding that that negative emotional responses significantly influences individual behavior)

<sup>103</sup> See Rashmi Dyal-Chand, *Human Worth as Collateral*, 38 *RUTGERS L.J.* 793 (2007) (noting “[c]redit card lenders, on the other hand, do seem to recognize the power of shaming their borrowers, though they may not explicitly describe it as such”).

<sup>104</sup> Guiso et al., *supra* note 11, at 22; *Id.* at 2 (reporting that “strategic defaults may produce contagion effects”).

few people in a neighborhood walk, others will follow, until whole neighborhoods end up as empty wastelands.<sup>105</sup> Indeed, geographical patterns already show that foreclosures cluster in neighborhoods,<sup>106</sup> suggesting that once foreclosure is seen as acceptable within a given community, and an individual knows others who have survived foreclosure, there may be less reason to feel ashamed of one's decision to walk or to fear the consequences.

Alarmed by the possibility that foreclosures may reach a tipping point, formal federal policy has aimed to stem the tide of foreclosures through programs designed to "reduce household cash flow problems," such as the Making Home Affordable (MHA) loan modification program<sup>107</sup> and Hope For Homeowners.<sup>108</sup> Implicit in this approach is the assumption that home owners are unlikely to default on their mortgage if they can "afford"<sup>109</sup> the monthly payment. In other words, federal policy assumes that homeowners are – for the most part - not "ruthless" and won't walk away from their mortgages simply because they have negative equity.<sup>110</sup> Most homeowners walk only when they can no longer afford to stay. As evidence of this fact, only 45% of homeowners would walk even if they had \$300,000 in negative

---

<sup>105</sup> Guiso et al., *supra* note 11, at 20; John P. Harding, Eric Rosenblatt, & Vincent W. Yao, *The Contagion Effect of Foreclosed Properties*, J. OF URB. ECON. 21 (2008), available at <http://ssrn.com/abstract=1160354> (noting that "nearby distressed property has a significant, negative effect on the prices of nearby homes over and above the overall trend in market prices").

<sup>106</sup> Guiso et al., *supra* note 11, at 6.

<sup>107</sup> See Making Home Affordable, <http://makinghomeaffordable.gov/about.html> (last visited Oct. 9, 2009) (explaining that the Making Home Affordable program aims "to strengthen the national economy by providing homeowners whose homes have decreased in value, thereby inhibiting their ability to refinance to a lower rate within the private sector, with a more affordable monthly option for their mortgage payments...").

<sup>108</sup> See Hope for Homeowners,, <http://www.hud.gov/hopeforhomeowners/> (last visited Oct. 9, 2009). The HOPE website describes the program as follows:

Under the program, borrowers having difficulty paying their mortgages will be eligible to refinance into FHA-insured mortgages they can afford. For borrowers who refinance under *HOPE for Homeowners*, lenders will be required to "write down" the size of the mortgage to a maximum of 90 percent of the home's new appraised value.

<sup>109</sup> Guiso et al., *supra* note 11, at 19.

<sup>110</sup> See ROBERT AVERY ET. AL., CREDIT RISK, CREDIT SCORING, AND THE PERFORMANCE OF HOME MORTGAGES (1996), available at <http://www.federalreserve.gov/pubs/bulletin/1996/796lead.pdf> (noting that credit risk models reflect fact that few borrowers are "ruthless").

equity.<sup>111</sup> This percentage drops to 38% among the subset of individuals who believe it is immoral to strategically default on one's mortgage (a subset to which 87% of homeowners belong).<sup>112</sup>

These numbers suggest that the "moral constraint" is a powerful one indeed – and that, for most people, only the complete inability to afford their mortgage would push them to default. On the other hand, the fact that 63% of "amoral" individuals would default at \$300,000 in negative equity, and 59% would do so at \$200,000,<sup>113</sup> suggests that federal policy can only proceed on the premise that affordability is the prime consideration as long as the moral and social constraints on foreclosure remain strong. The government thus has an incentive, along with certain other economic and social institutions interested in limiting the number of foreclosures, in cultivating guilt and shame in those who would contemplate walking away. Similarly, knowing that guilt and shame alone are not enough to prevent many individuals from defaulting once negative equity is extreme, these same institutions have an interest in increasing the perceived cost of foreclosure by cultivating fear of financial disaster for those who contemplate it.

This is not to say that there is a grand scheme to manipulate the emotions of homeowners, or even that the government and other institutions consciously cultivate these emotional constraints on default.<sup>114</sup> But, to be sure, the predominate message of political, social, and economic institutions in the United States has functioned to cultivate fear, shame, and guilt in those who might contemplate foreclosure. These emotions in turn function as a form of internalized social control –encouraging conformity to the norm of meeting one's mortgage obligations as long as one can afford to do so.<sup>115</sup>

The clear message to American homeowners from nearly all fronts is that one has a moral responsibility to pay one's mortgage. The message is conveyed not only by political, social, and economic institutions, but by the majority of Americans who believe that voluntarily defaulting on a mortgage is immoral. At the political level, government spokespersons, including President Obama, have repeatedly emphasized the virtue of homeowners who have acted "responsibly" in "making their payments each

---

<sup>111</sup> See generally Guiso et al., *supra* note 11.

<sup>112</sup> *Id.*

<sup>113</sup> GUIISO ET AL., *supra* note 11, at 10.

<sup>114</sup> Social control is defined by most contemporary scholars "as attempts, whether intentional or not, by the state or social institutions to regulate or encourage conformity to a set or norms through socialization or the threat of coercion, or both," David Pearce Demers and K. Viswanath, MASS MEDIA, SOCIAL CONTROL, AND SOCIAL CHANGE 9 (1998)

<sup>115</sup> *Id.* (noting that social control is most effective when "external control comes to be incorporated into the personality of the individual.")

month”<sup>116</sup> and have lamented the erosion of “our common values” by, for example, those who irresponsibly borrowed beyond their means.<sup>117</sup> The worst criticism has been reserved, however, for those who would walk away from mortgages that they can afford. Typical of such criticism is that of Secretary of the Treasury Henry Paulson, who declared in a televised speech: “And let me emphasize, any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator – and one who is not honoring his obligations.”<sup>118</sup>

Paulson’s comment is mild, however, compared to the media invective toward those who strategically walk from their mortgages. Such individuals are portrayed as obscene,<sup>119</sup> offensive,<sup>120</sup> and unethical,<sup>121</sup> and likened to deadbeat dads who walk out on their children,<sup>122</sup> or those who would have “given up” and just handed over Europe to the Nazis.<sup>123</sup>

There is similarly no shortage of moralizing about the responsibilities of mortgagors. Typical media messages include: “we need a culture of responsible consumers and homeowners;”<sup>124</sup>

---

<sup>116</sup> President Barack Obama, Foreclosure Speech: Housing Plan, (Feb. 18, 2009), available at [http://www.huffingtonpost.com/2009/02/18/obama-foreclosure-speech\\_n\\_167889.html](http://www.huffingtonpost.com/2009/02/18/obama-foreclosure-speech_n_167889.html)

<sup>117</sup> *Id.*

<sup>118</sup> Secretary Henry M. Paulson, Jr., U.S. Housing and Mortgage Market Update before the National Association of Business Economists (Mar. 3, 2008), <http://www.ustreas.gov/press/releases/hp856.htm>.

<sup>119</sup> *Fox Business: Some Homeowners Who Can’t Pay Choosing to Just Walk Away* (Fox Business television broadcast Feb. 19, 2009), available at <http://www.foxbusiness.com/video/index.html?playerId=videolandingpage&streamingFormat=FLASH&referralObject=3644995&referralPlaylistId=1292d14d0e3afdcf0b31500afefb92724c08f046> [hereinafter “Fox Business”]. (“Seems obscene. Everyone else in the country is trying to pay their mortgages and trying to get things done. They realize in many cases they are underwater that their mortgage is worth more than their home. If you have obnoxious kids, walk away from your kids. Seems weird. Doesn’t it?”)

<sup>120</sup> *Id.* (“I know you are not looking at the ethics of this; you are a good and savvy businessman. Do you find it even a tinge offensive that we are moving away from personal responsibility? If we can’t hack it we bail out of it.”)

<sup>121</sup> The Mike Gallagher National Radio Show, *Youwalkaway.com* (Townhall, May 1, 2009).

<sup>122</sup> *Fox Business*, *supra* note 115.

<sup>123</sup> *Id.* (“And you know when you enter into an agreement and everyone just throws up the keys and says you know it’s really tough this month, it’s gonna be tough next month, declining real estate values, we are just going to quit. Can you imagine if we all did that going into World War II? The Japanese just kicked our butts at Pearl Harbor, the odds are overwhelming, the Germans have just taken over Europe, and we just quit. What would happen if we all quit? Let’s just cease and desist.”)

<sup>124</sup> *Economy: Why Not Just Walk Away From A Home?* (NPR radio broadcast Feb. 13, 2008) available at

“one should always honor financial obligations;<sup>125</sup> “when you enter into a contract that should mean something;”<sup>126</sup> “there was a time when people felt really bad about not paying back debt,”<sup>127</sup> and, “money is more than a matter of numbers. There are ethics involved. Most people feel, or should feel, an obligation to pay their debts.”<sup>128</sup> Even sympathy for those who default because of predatory lending is frequently lacking: “We’ve read too many sob stories in the press about ‘predatory lending’ — a rare, misunderstood, and vastly exaggerated phenomenon. It’s time for the poster children for irresponsibility to get some face time.”<sup>129</sup>

Indeed, a homeowner contemplating a strategic default would be hard pressed to avoid the message that doing so would place them among the most despicable members of society. It is thus not surprising that a large number of media stories about individuals who walk on their mortgages indicate that these individuals ask that their “last name not be used” to protect their privacy.<sup>130</sup> Nobody wants to be indentified as a deadbeat – or, as one commentator describes them, “a blight on our society.”<sup>131</sup> Such individuals seek to protect their privacy for good reason, as it is not just the media and the government that acts as norm enforcers, but also individuals – as can be seen in the frequent railings on internet comment boards and blogs about strategic defaulters. In one typical example, “Bob Green”, an individual enraged by the story of “Raam” who posted his own story of why he strategically defaulted on his mortgage, wrote: “Amazing. Simply amazing. The types of speculators like ‘Raam’ and others should be tied to a tree and left to rot. It’s these fine people who are going to walk away and leave the societal, writ large, on the

---

<http://www.npr.org/templates/story/story.php?storyId=18958049> [hereinafter “NPR”].

<sup>125</sup> *Id.*

<sup>126</sup> *Fox Business*, *supra* note 119.

<sup>127</sup> *60 Minutes: The U.S. Mortgage Meltdown* (CBS television broadcast May 25, 2008), available at <http://www.cbsnews.com/video/watch/?id=4126094n&tag=related:photovideo>.

<sup>128</sup> *Weston*, *supra* note 2.

<sup>129</sup> Steven Spruiell, *Obama Pays Bail Money*, NATIONAL REVIEW ONLINE, June 12, 2008, <http://article.nationalreview.com/?q=OWJkNGE3ZjlyYTAzOTg0MWJlYmViM2FIZGVjMjY4ZmY=> [hereinafter “National Review”].

<sup>130</sup> *Weston*, *supra* note 128, at 3.

<sup>131</sup> Brian Eckhouse, *Whether to Walk Away: Housing’s Moral Minefield*, LAS VEGAS SUN, Mar. 22, 2009, <http://www.lasvegassun.com/news/2009/mar/22/whether-walk-away-housings-moral-minefield/>

hook for their problems. Good job Raam—way to take responsibility.”<sup>132</sup>

Moreover, a homeowner who turned to any number of credit counseling agencies would also find little sympathy - and much moralizing - should they announce their plan to walk on their “affordable” mortgage. Gail Cunningham of the National Foundation for Credit Counseling declared for example in an interview on NPR: “Walking away from one's home should be the absolute last resort. However desperate a situation might become for a homeowner, that does not relieve us of our responsibilities.”<sup>133</sup> Indeed, the uniform message of both governmental and non-profit counseling agencies (which are

---

<sup>132</sup> Posting of Bob Green to <http://www.mint.com/blog/finance-core/should-you-walk-away-from-your-home/>. “Raam” tells his story as follows:

I purchased my first rental property at the age of 21. Everyone said I would make a killing and was really smart for investing so young. I wish I had done more research and seen that we were approaching an inevitable bubble. I bought my first property (a 2-family) for \$190k in 2003. Within a year it was valued at double that. After refinancing and putting money into the first property, I bought two more properties the following two years. I had 12 tenants total (being a landlord is no easy task!). The mortgage lenders were pushing ARM's like crazy... and they made sense to an investor like me. I needed the lowest monthly payment so I could take the little income left from the rent to put back into the properties. Plus, I could always just refinance my 2-year fixed / 28 year adjustable mortgage before the 2 years-fixed were up (refinance to a conventional 30-year fixed)... right? Well, taxes went way up. I had a few tenants that cost me over \$15k in lost rent (damn tenant-rights laws!), unexpected property damage from frozen water pipes, a couple more bad tenants, and while all this was happening the value of my house secretly dropped below the amount I owed... oh sh\*t. Then I get a letter in the mail saying my monthly mortgage payments are going to increase by more than \$600 a month... but wait, I'm already dishing out over \$200 a month from my pocket to pay for the properties (assuming all the units are fully rented)! I can't refinance because the value of the property is less than what I owe. I can bust my ass for the next 5-10 years trying to keep up with the payments or I can let everything fall down, file for bankruptcy, and move on. I'm filing. And I'm damn glad. \$450k multi-family properties are now for sale at \$140k... less than I bought my first property in 2003. For me it's easy because they were investment properties, not houses my family lived in (I'm single). I'm renting now and saving as much money as I can, because when things start to turn around I want to be ready, not buried under a million dollars in debt. Posting of “Raam” to: <http://www.mint.com/blog/finance-core/should-you-walk-away-from-your-home/>.

<sup>133</sup> NPR, *supra* note 124.

typically funded at least in significant part by the financial industry) is that “walking away” is not a responsible choice<sup>134</sup> and should be avoided at all costs.<sup>135</sup>

What makes this moral suasion so effective is that major socializing agents in the United States tend to speak with one voice. Thus, when the government, or the credit industry, tells individuals that they have a responsibility to pay their mortgage even if they are seriously underwater, the message is seen as “echoing a deep-seated American belief that one should always honor financial obligations,”<sup>136</sup> – and not as an effort to fix the primary burden of the housing meltdown on homeowners rather than the financial industry or the government. More critically, because the media and non-profit consumer counseling agencies promote the same message, the government and the financial industry need not bear the primary burden of moral suasion – nor is the message ever identified with those political and economic institutions that have a vested interest in promoting “homeowner responsibility.” The message rings true to the ear and, as such, most homeowners question neither the content of the message, nor its source.<sup>137</sup>

Social control of would be defaulters is not limited to moral suasion, however. Predominate messages regarding foreclosure also frequently employ fear to persuade homeowners that strategic default is a bad choice:

---

<sup>134</sup> See, e.g., Fannie Mae, Foreclosure Prevention FAQs (answering the question “is it best to walk away from my property if I can no longer make the payments?” as follows: “Walking away from your property is not a good choice. Continue to live in your house as long as you are trying to get help from your mortgage company or through a housing counselor.”). Available at <http://www.fanniemae.com/homeowners/frequently-asked-questions.html> (last visited Oct. 9, 2009)

<sup>135</sup> HUD, How to Avoid Foreclosure, <http://www.hud.gov/offices/adm/hudclips/forms/files/pa426h.pdf> (last visited Oct. 15, 2009) (stressing to homeowners that “you should avoid foreclosure if possible” and “[d]on’t lose your home and damage your credit history”); see also Anaheim Housing Counseling Agency, <http://www.anaheimhousingcounselingagency.org/id21.html> (last visited Oct. 9, 2009) (“Losing your home can be the worst and most devastating event to you personally, and your credit history. This is a scenario that you don’t want to occur if you can avoid it.”); see also, Foreclosure Avoidance Counseling, <http://www.hud.gov/offices/hsg/sfh/hcc/fc/> (last visited Oct. 9, 2009) (“HUD-approved housing counseling agencies are available to provide you with the information and assistance you need to avoid foreclosure.”).

<sup>136</sup> NPR, *supra* note 124 (quoting, Gail Cunningham, spokeswoman for the National Foundation for Credit Counseling).

<sup>137</sup> See JOHN O'SHAUGHNESSY & NICHOLAS JACKSON O'SHAUGHNESSY, THE MARKETING POWER OF EMOTION 61 (2003) (explaining that individuals tend to uncritically endorse information that in line with their affective predispositions).

What is real--and what is very much downplayed by these outfits [like YouWalkAway.com] --is how completely a foreclosure wrecks your finances. Near term, you might get slammed with a massive tax bill, since forgiven debt can be subject to income tax. Long term, car loans and--you guessed it--home loans will be much harder to come by. How's that for walking away? This is the American Dream ended in disaster".<sup>138</sup>

Indeed, almost every media story on those who “walk away from their mortgages” condemns the behavior as immoral and enlists some “expert” to explain that foreclosure is, despite any claims to the contrary, a devastating event.<sup>139</sup>

---

<sup>138</sup> Barbara Kiviat, *Walking Away From Your Mortgage*, TIME, June 19, 2008, available at <http://www.time.com/time/magazine/article/0,9171,1816472,00.html> (quoting Odette Williamson, a foreclosure lawyer at the National Consumer Law Center).

<sup>139</sup> See, e.g., Kiviat, *supra* note 138:

The whole idea of walking away is troubling to consumer advocates, who worry that these firms are whitewashing the fact that foreclosure is a traumatic experience--both financially and emotionally--that takes years to recover from.”

And, *Nightline: The Big Cut* (ABC Television broadcast Jan. 31, 2008), available at <http://abcnews.go.com/Video/playerIndex?id=4220208&affil=wxyz> :

The thing is you have to take into consideration here is that this is a real disaster for your credit, if you have a foreclosure on your record, even default. But if you fall behind on your mortgage, and don't pay it, everyone you go to borrow money from for the next 6-7 years is going to know about this. When you try to find a job, when you try to rent an apartment, this is going to be on your credit. It's not like you walk away free, you walk away with a huge black mark on your credit rating.”

See also John A. Schoen, *Why It's a Bad Idea to Walk Away From the Mortgage*, MSNBC, March 16, 2009, <http://www.msnbc.msn.com/id/29669640/> (editorializing that “[t]he most important reason [why is a bad idea to walk away]: You signed a contract, took the money and promised to pay the lender back. That's what the law now requires you to do”; and going on to explain that foreclosure will destroy your credit”); *Fox Business*, *supra* note 119; *Nightline*, *supra* note 139; NPR, *supra* note 124; *Weston*, *supra* note 2.; *Santelli's Tea Party* (CNBC television broadcast Feb. 19, 2009) available at <http://www.cnn.com/id/15840232?video=1039849853>; Streitfeld, *supra* note 2; NATIONAL REVIEW, *supra* note 129; *Can't Pay, Won't Pay*, ECONOMIST, July 25, 2009,

A single missed mortgage payment, says MSN Money columnist and credit expert Liz Pulliam Weston, knocks 100 points off your credit score. Every missed payment thereafter compounds the damage. A notice of default typically comes after the third missed payment, delivering a knockout blow to the homeowner's credit. ... The direct effect of any of these outcomes on credit scores is dramatic, and it ripples through every corner of borrowers' financial lives. The former homeowners will be unable to get new credit at reasonable rates, and issuers of their existing credit cards can raise interest rates because they are considered greater risks.<sup>140</sup>

Similar warnings of disaster pervade the information given to homeowners by HUD-approved housing counseling agencies,<sup>141</sup> such as the following from the Anaheim Housing Counseling Agency:

Losing your home can be the worst and most devastating event to you personally, and your credit history. This is a scenario that you don't want to occur if you can avoid it! Not only will you lose the comfort of your home and your investment, but a Foreclosure will stay pending on your credit history for as long as 10 years. This will jeopardize your ability to qualify for any future home loan purchases, it may affect your ability to access loans for car purchase and other needed purchases, and

---

[http://www.economist.com/businessfinance/displayStory.cfm?story\\_id=13905502](http://www.economist.com/businessfinance/displayStory.cfm?story_id=13905502).

<sup>140</sup> HASSON, *supra* note 89.

<sup>141</sup> Clearpoint Credit Counseling Solutions, Default and Foreclosure Counseling,

[http://www.bydesignsolutions.org/default\\_and\\_foreclosure\\_counseling.html](http://www.bydesignsolutions.org/default_and_foreclosure_counseling.html)

(last visited Oct. 10, 2009) (“For homeowners, the thought of losing your home in a foreclosure is frightening. Your mortgage payment is usually your single largest financial obligation.”); *see also* GreenPath Debt Solutions, Housing Counseling,

<http://www.greenpath.com/how-we-can-help/housing-counseling.htm> (last visited Oct. 10, 2009) (“Greenpath’s housing counseling services can help you preserve your most important asset, your home. After all, tenants, homeowners and future home purchasers have a lot to lose if their finances get out of control-and a lot to gain from housing counseling delivered by an unbiased housing counselor.”).

loan costs are likely to be higher both in fees and interest paid.<sup>142</sup>

As discussed above, fear alone is a powerful motivator. But guilt and fear in combination are even more potent.<sup>143</sup> This may be because most individuals have a deep-seated, if ill-defined, sense that if they do “bad things,” bad things will happen to them. Whatever the psychological underpinnings, most people simply do not believe they will escape punishment for their moral transgressions. Guilt and fear of punishment go together. Thus, the notion that one will suffer great consequences for walking away from one’s financial obligations not only seems possible, but feels quite right. It just can’t be that one can walk away from their mortgage with no significant consequence. As such, people rarely question apocalyptic descriptions of foreclosure’s consequences.

As explored above, however, there is in fact a huge financial upside to strategic default for seriously underwater homeowners – an upside that is routinely ignored by the media, credit counseling agencies, and other political and economic institutions in “informing” homeowners about the consequences of

---

<sup>142</sup> Anaheim Housing Counseling Agency, <http://www.anaheimhousingcounselingagency.org/id21.html> (last visited Oct. 10, 2009); *see also* Fannie Mae, Foreclosure Prevention FAQs, <http://www.fanniemae.com/homeowners/frequently-asked-questions.html> (last visited Oct. 10, 2009) warning:

Foreclosures are extremely damaging to your credit and may impact your credit rating for as long as seven years. A foreclosure can make it difficult to get a loan for a future home purchase, college expenses, or to get a major credit card. If you are able to get credit, your interest rates will likely be higher. For most people, it is well worth the time and effort to avoid foreclosure.

*See also*, NPR, *supra* note 124 (quoting Ellen Schloemer, director of research at the Center for Responsible Lending, for the proposition that “[i]t takes a decade to recover from a foreclosure.”).

<sup>143</sup> *See, e.g.*, Dwight Merunka et. al., *Modeling and Measuring the Impact of Fear, Guilt and Shame Appeals on Persuasion for Health Communication: a Study of Anti-Alcohol Messages* (Working Paper, 2007)(finding that their study showed “that a threatening message implying fear, guilt and shame together might well be the most persuasive.”), available at: <http://ssrn.com/abstract=963593>. *See also*, Linda Brennan & Wayne Binney, *Fear, Guilt, and Shame Appeals in Social Marketing*, J. BUS. RESEARCH (2009); Lauren G. Block, *Self-Referenced Fear and Guilt Appeals: The Moderating Role of Self-Constraint*, 35 J. APPLIED SOC. PSYCH. 11 (2005); Francesco Mancini & Amelia Gangemi, *The Role of Responsibility and Fear of Guilt in Hypothesis-Testing*, 37 J. BEHAVIOR THERAPY & EXPERIMENTAL PSYCHIATRY 333 (2006); *see also* *Guilt And Fear Motivate Better Than Hope*, SCIENCE DAILY, <http://www.sciencedaily.com/releases/2006/02/060213091147.htm> (last visited Sept. 17, 2009).

default. Moreover, the costs of default are not nearly as extreme as these same institutions typically misrepresent them to be. In reality: lenders are not able to pursue individuals for deficiency judgments in many states because of non-recourse laws (laws that homeowners are rarely informed of);<sup>144</sup> even in recourse states, lenders are unlikely to pursue a deficiency judgment because it is economically inefficient to do so;<sup>145</sup> there is no tax liability on “forgiven portions” of home mortgages under current federal tax law in effect until 2012;<sup>146</sup> defaulting on one’s mortgage does not mean that one’s other credit lines will be revoked;<sup>147</sup> and most people can expect to recover from the negative impact of foreclosure on their credit score within a two-to-three years<sup>148</sup> (and, meanwhile, a few years of poor credit need not seriously impact one’s life).

Homeowners with high credit scores, however, may have an especially hard time accepting the notion that a few years of poor credit is no big deal. The hard to convince include the vast majority of homeowners with prime loans, 94% of whom had credit scores above 660 when they purchased their homes.<sup>149</sup> Most American homeowners see their good credit scores not only in utilitarian terms (i.e. – as helpful in increasing one’s purchasing power) but also as a “source of pride,” or a statement of their good moral character.<sup>150</sup> Indeed, the view that one’s credit score reflects one’s character, or at least one’s sense of personal responsibility and trustworthiness, is widespread in American culture.<sup>151</sup> This belief is not surprising given that the federal

---

<sup>144</sup> John Caulfield, *Senate Considers Foreclosure Relief Bill Today*, BUILDER ONLINE 2, Feb. 27, 2008, <http://www.builderonline.com/business/senate-considers-foreclosure-relief-bill-today.aspx> (noting that even YouWalkAway.com founder was “a neophyte in this area” and did not “know much about the laws”).

<sup>145</sup> Ralph Roberts, *Top Myths About Loan Modification*, REALTY TIMES (Jan. 6, 2009) [http://realtymtimes.com/rtpages/20090126\\_myths.htm](http://realtymtimes.com/rtpages/20090126_myths.htm).

<sup>146</sup> Christie, *supra* note \_\_\_ at 2.

<sup>147</sup> See Mortgage Forgiveness Debt Relief Act of 2007.

<sup>148</sup> Christie, *supra* note \_\_\_ at 1-2; Nina Silberstein, *How Foreclosure Affects Your Credit Score*, AOL REAL ESTATE, [http://realestate.aol.com/article/credit/\\_a/how-foreclosure-affects-your-credit-score/2009041001](http://realestate.aol.com/article/credit/_a/how-foreclosure-affects-your-credit-score/2009041001). (last visited Oct. 10, 2009).

<sup>149</sup> ROBERT AVERY ET. AL., CREDIT RISK, CREDIT SCORING, AND THE PERFORMANCE OF HOME MORTGAGES (1996), available at <http://www.federalreserve.gov/pubs/bulletin/1996/796lead.pdf> (noting that 93.6% of conventional fix-rate mortgages have credit scores in the high range, meaning above 660).

<sup>150</sup> Rashmi Dyal-Chand, *Human Worth as Collateral*, 38 RUTGERS L.J. 793 (2007) (“A good credit score itself is now something about which to be proud, and a bad credit score is something about which to be ashamed”).

<sup>151</sup> See *id.* at 793 (noting that “there appears to be a growing trend of using credit reports as a proxy for screening and decision-making processes

statute that governs credit reporting, the Fair Credit Reporting Act (“FCRA”), describes credit reporting as a “mechanism for investigating and evaluating the credit worthiness, credit standing, credit capacity, *character, and general reputation of consumers.*”<sup>152</sup>

A bad credit score is – by design - meant to reflect not only one’s poor creditworthiness, but also one’s poor moral character. For individuals to lose their good credit is thus to lose not only “their self-conceptions as people who keep their promises and pay their debts on time,” but part of their “human worth” as well.<sup>153</sup> Even being “perceived as having bad credit” – such as having one’s credit card turned down at a restaurant – is deeply humiliating to most Americans.<sup>154</sup> A bad credit score is nothing less than a reputational scarlet letter that, because of the “omnipresence of the credit reporting system,”<sup>155</sup> follows individuals wherever they go. As a result, Americans engage in a great deal of “self-regulation in order to maintain good credit scores.” The lending industry in turn “uses credit scores as a threat” to constrain borrower behavior.<sup>156</sup>

This power to threaten borrowers means that though mortgage agreements in non-recourse states contain an implied *put option*, or contractual option to default and transfer ownership of the home to the lender, the law plays a subordinate role in lender-borrower relations. A borrower might in fact walk without *legal* penalty, but the lender holds the borrower’s human worth as collateral – and will likely trash it in retaliation for the borrower’s exercise of their contractual right to default.<sup>157</sup> The credit reporting system thus subordinates the law to social norms, and makes it impossible for a strategic defaulter to avoid the reputational penalty of default, - even by packing up and moving across the country. Indeed, for seven years, perfect strangers who access the defaulter’s credit report will learn of the moral misdeed

---

outside the context of credit transactions, and in contexts where character was once assessed in a more holistic manner. For instance, some relationship experts now recommend using credit reports to evaluate the trustworthiness and suitability of a potential romantic partner, while some businesses forego the interview screening process entirely in favor of the information about an individual that may be gleaned from a credit report”).

<sup>152</sup> 15 U.S.C. § 1681(a)(2) (2000)(emphasis added).

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> *Id.* (“In the consumer context, the connection between credit reports, credit, and social status provides a means of eliminating a person's sense of honor. Simply put, by reporting negative information to a credit bureau, a lender can limit a borrower's acquisition of status-enhancing goods and services, and more basically, lower her social standing”).

and express their disapproval, if only by changing their tone of voice in the way that individuals tend to do when addressing someone of a lesser social status.<sup>158</sup>

In short, although the financial sting of a temporarily poor credit score may be relatively easy to mitigate,<sup>159</sup> the damage to one's reputation and sense of self worth may be both more intense and more enduring. This reality brings the question back full circle to whether seriously underwater homeowners may be acting in utility-maximizing ways by not walking away from their mortgages. Indeed they may be - if emotional suffering is as a mere transaction cost of default. But whether the behavior is utility-maximizing misses the point. The point is that the credit reporting system operates in conjunction with other economic, political and social institutions as means of social control by increasing the emotional cost of default. Moreover, the credit reporting system operates largely outside legal process as a norm enforcer,<sup>160</sup> ensuring immediate reputational punishment for those individuals who might be tempted to flout their "moral commitment to pay" by exercising their legal right to default.

## **VI. The Asymmetry of Homeowner and Lender Norms**

One obvious response to the above discussion is that society benefits when people honor their financial obligations and behave according to social and moral norms, rather than strictly legal or market norms. This may be true if lenders behaved according to the same social and moral norms. In the case of lender-borrower behavior, however, there is a clear imbalance in placing personal responsibility on the borrower to honor their "promise to pay" in order to relieve the lender of their agreement to take back the home in lieu of payment. Given lenders generally superior knowledge and understanding of both mortgage instruments and valuation of real estate, it seems only fair to hold

---

<sup>158</sup> Seven years is the length of time that the fact of the foreclosure remains on an individual's credit report (though its effect on the actual score will effectively disappear long before then).

<sup>159</sup> For example, one might make any purchases for which one will foreseeably need credit before default and use a debit card in place of a credit card for purchases and rental car reservations after default.

<sup>160</sup> The credit reporting system is governed by the Fair Credit Reporting Act ("FCRA") 15 U.S.C. § 1681. The "system" consists of a "consumer report," defined by the FCRA as "any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living which is used or expected to be used or collected in whole or in part for the purpose of serving as a factor in establishing the consumer's eligibility for credit, insurance, or any other purpose permitted by the FCRA. 15 U.S.C. § 1681a(d)(1)"

them to the benefit of their bargain. At a basic level, sound underwriting of mortgage loans requires lenders to ensure that a loan is sufficiently collateralized in the event of default.<sup>161</sup> In other words, in appraising a home the lender should ensure that the loan amount, at the least, does not exceed the intrinsic market value of the home.

As discussed above, a textbook premise of economics is that a home's value, even an owner occupied one, is "the current value of the rent payments that could be earned from renting the property at market prices."<sup>162</sup> As such, historical home prices have hewed nationally to a price-to-annual-rent ratio of roughly 15-to-1.<sup>163</sup> At the peak of the market, however, price-to-rent ratios reached 38-to-1 in the most inflated markets, and the national average reached 23-to-1.<sup>164</sup> If personal responsibility is the operative value, then lenders who ignored basic economic principles (of which they should have been aware) should bear at least equal responsibility to homeowners for issuing collateralized loans that were far in excess of the intrinsic value of the home.

Moreover, since lenders generally arrange the appraisal (which home buyers must pay for) and home buyers rely upon the lender to ensure the home is worth the purchase price,<sup>165</sup> one might argue that lender should bear much more than 50% responsibility for the bad investment of the homeowner and lender. As Joseph Stiglitz has explained, "for the most part, the lenders were, or should have been, far more financially sophisticated than the borrowers."<sup>166</sup> Lenders "should [thus] be made to bear the consequences of their failures to assess risk."<sup>167</sup>

Indeed, lenders' mortgage default risk models have long shown that the loan-to-value ratio is a critical factor in default

---

<sup>161</sup> See e.g., Financial Web, Mortgage Loan Underwriting, <http://www.finweb.com/mortgage-loan-education/mortgage-loan-underwriting.html> (last visited Oct. 10, 2009)

<sup>162</sup> JIN RHO, ET. AL., *supra* note 25, at 3.

<sup>163</sup> *Id.* at 4.

<sup>164</sup> Shawn Tully, *Real Estate: Buy, Sell, or Hold*, FORTUNE, Nov. 7, 2007, available at [http://money.cnn.com/2007/11/06/real\\_estate/home\\_prices.fortune/index.htm](http://money.cnn.com/2007/11/06/real_estate/home_prices.fortune/index.htm)

<sup>165</sup> See James Hagerty, *Reappraising Home Appraisers*, WALL ST. J., Aug. 18, 2009 (noting that, "Appraisals are supposed to shield home buyers from paying too much and lenders from overestimating the value of collateral. If appraisals come in too high, buyers may overpay, making defaults more likely.").

<sup>166</sup> Memorandum from Joseph E. Stiglitz to The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, 1, available at [http://www.un-gls.org/docs/ga/cfr/memo\\_foreclosures.pdf](http://www.un-gls.org/docs/ga/cfr/memo_foreclosures.pdf)

<sup>167</sup> *Id.*

risk.<sup>168</sup> Lender underwriting practices thus traditionally required that homeowners have sufficient equity (usually by making a sufficient down payment) such that default would never be the “in the money option.”<sup>169</sup> Lenders relaxed this requirement, however, as credit default models showed that few borrowers were “ruthless,” meaning that few borrowers default as soon as the loan value exceeds the market value of the home.<sup>170</sup> Lenders thus moved toward models that relied heavily on credit history as the predictor of default risk. These models showed, for example, that only 0.9% of borrowers with “high” credit scores and 4% of borrowers with “medium” credit scores default on their mortgages.<sup>171</sup> This led lenders to conclude that default risk was sufficiently low for borrowers with high and medium credit scores that lenders could profitably offer a variety of alternative mortgage products including zero-down loans, interest-only ARMS, and negative amortization loans.<sup>172</sup>

In other words, lenders lost sight of the importance of positive equity in lowering the risk of mortgage default, and failed to ensure that homes were actually worth what they were being purchased for.<sup>173</sup> This is not to say that lenders are solely responsible for the housing run-up and bust, but that they do in fact bear a substantial portion of the blame – and thus should thus bear a substantial portion of the cost.<sup>174</sup> One might argue, in fact, that the value of personal responsibility would require lenders to own up to their share of the blame, and work with underwater

---

<sup>168</sup> Vandell, *supra* at 215 (noting the LTV’s dominant effect on mortgage default was initially validated in the 1970 Herzog and Earley study).

<sup>169</sup> *Id.* at 212-213, 218.

<sup>170</sup> *Id.* at 224 (finding that the first option-based models overestimated the ruthless default of homeowners in comparison to that which was actually observable in the market).

<sup>171</sup> See AVERY ET. AL., *supra* note 145.

<sup>172</sup> See Kerry D. Vandell, *Handing Over the Keys, A Perspective on Mortgage Default Research*, 21 J. AM. REAL ESTATE & URBAN ECON. ASS’N 211 (1993)

<sup>173</sup> See, e.g., CNBC.com, *Boom, Bust and Blame - The Inside Story of America’s Economic Crisis*, <http://www.cnbc.com/id/32756455/> (last visited Oct. 10, 2009) (noting that “[f]inancial institutions big and small got caught up in the lending frenzy. Some were fly-by-night operations that made millions through questionable loans. Others were well-known firms with strong reputations, blinded by the promise of huge mortgage profits.”).

<sup>174</sup> Of course, others share in the blame as well, including mortgage brokers and appraisers who conspired to inflate home values, see e.g., LARRY NEUMEISTER, *41 people in 4 states charged in mortgage fraud*, Associated Press Wire, October 15, 2009 (on file with author), and buyer’s real estate agents, who pushed buyers to buy at inflated prices and failed to warn of an impending bust that they knew, or should have known, was coming – or at the very least failed to inform buyers once monthly trends began to show declining prices. See Lew Sichelman, *Legal battles over real estate transactions increase*, LOS ANGELES TIMES, October 4, 2009.

homeowners by voluntarily writing off some of the negative equity.

But lenders, of course, do not operate according norms of personal responsibility, and seek instead to maximize profit (or minimize losses). Indeed, to the extent that the lender is a corporation, the directors and executives of the corporation have a legal duty to shareholders to maximize profit and/or minimize losses. Appealing to this duty, it has been suggested that, given the great cost to lenders of foreclosure, they have an economic incentive to modify loans for homeowners in danger of default.<sup>175</sup> This argument has flown in the face of the reality, however, that lenders have been reluctant to modify loans, even for borrowers in the pre-foreclosure process.<sup>176</sup>

Recent studies seeking to explain this apparently irrational behavior have shown that lenders are simply operating to maximize profit and minimize losses, just as they would be expected to do.<sup>177</sup> First, lenders know that borrowers with high credit scores are unlikely to default even at high levels of negative equity.<sup>178</sup> To modify loans for these homeowners would be to throw money away – and to encourage more homeowners to ask for modifications. Second, many homeowners who temporarily default on their mortgages “self-cure” without any help from their lender.<sup>179</sup> Again, to modify the loans of these individuals would be to throw money away. Third, homeowners with poor credit, or who end up in arrears because of “triggering events” such as

---

<sup>175</sup> MORTGAGE BANKER’S ASSOCIATION, LENDER’S COST OF FORECLOSURE, (2008), available at <http://www.nga.org/Files/pdf/0805FORECLOSUREMORTGAGE.PDF> (explaining that foreclosure is a prohibitively costly exercise for the mortgage industry as it involves significant lost payments on principle, interest, as well as necessitating legal, administrative, and property maintenance fees, all of which are incurred by the lender).

<sup>176</sup> Manuel Adelino, Kristopher Gerardi, & Paul Willen, *Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Federal Reserve Bank of Atlanta, Working Paper 2009-17, Aug. 2009), available at <http://www.frbatlanta.org/invoke.cfm?objectid=149C4D27-5056-9F12-12C089648203E1FD&method=display>.

<sup>177</sup> *Id.* See also Foote, et. al., *supra* note 14 at 1 (explain that “While investors might be foreclosing when it would be *socially* efficient to modify, there is little evidence to suggest they are acting against *their own* interests when they do so.”)(emphasis in original)

<sup>178</sup> Manuel Adelino, Kristopher Gerardi, & Paul Willen, *Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Federal Reserve Bank of Atlanta, Working Paper 2009-17, Aug. 2009), available at <http://www.frbatlanta.org/invoke.cfm?objectid=149C4D27-5056-9F12-12C089648203E1FD&method=display>

<sup>179</sup> See Foote, et. al., *supra* note 14 at 2 (noting, “Investors also lose money when they modify mortgages for borrowers who would have repaid anyway, especially if modifications are done *en masse*, as proponents insist they should be.”)

unemployment, divorce, or other financially devastating circumstances are likely to default on the modified loan as well.<sup>180</sup> To modify loans for these individuals is to waste time and risk housing prices falling further before the lender eventually has to foreclosure and sell the property anyway.

Given these economic incentives for the lender, a seriously underwater homeowner with good credit and solid mortgage payment history who responsibly calls his lender to work out a loan modification is likely to be told by his lender that it will not discuss a loan modification until the homeowner is 30 days or more delinquent on his mortgage payment.<sup>181</sup> The lender is making a bet (and a good one) that the homeowner values his credit score too much to miss a payment and will just give up the idea of a loan modification. However, if the homeowner does what the lender suggests, misses a payment, and calls back to discuss a loan modification in 30 days, the homeowner is likely to be told to call back when he is 90 days delinquent.<sup>182</sup> In the meantime, the lender will send the borrower a series of strongly-worded notices reminding him of his moral obligation to pay and threatening legal action, including foreclosure and a deficiency judgment, if the homeowner does not bring his mortgage payments current. The lender is again making a bet (and again a good one) that the homeowner will be shamed or frightened into paying their mortgage. If the homeowner calls the lender's bluff and calls back when he is 90 days delinquent, there is a good possibility that he will be told that his credit score is now so low that he does not qualify for a loan modification.<sup>183</sup> The homeowner must then decide whether to bring the loan current or face foreclosure. If the homeowner somehow makes clear to the lender that he has chosen foreclosure, the lender *may* finally be willing to negotiate a loan modification, a short-sale or a deed-in-lieu of foreclosure – all of which still leave the homeowner's credit in tatters (at least temporary).

---

<sup>180</sup> See *Id.* (“Moreover, the calculation [that lenders are acting against their own interest] ignores the possibility that borrowers with modified loans will default again later, usually for the same reason they defaulted in the first place.”); See also Manuel Adelino, Kristopher Gerardi, & Paul Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Federal Reserve Bank of Atlanta, Working Paper 2009-17, Aug. 2009)

<sup>181</sup> See Edmund L. Andrews, *My Personal Credit Crisis*, N.Y. TIMES, May 14, 2009, available at <http://www.nytimes.com/2009/05/17/magazine/17foreclosure-t.html?pagewanted=all> (describing the author's efforts to renegotiate his mortgage with his lender)

<sup>182</sup> *Id.*

<sup>183</sup> *Id.*

Most lenders will, in other words, take full advantage of the asymmetry of norms between lender and homeowner and will use the threat of damaging the borrower's credit score to bring the homeowner into compliance. Additionally, many lenders will only bargain when the threat of damaging the homeowner's credit has lost its force and it becomes clear to the lender that foreclosure is imminent absent some accommodation. On a fundamental level, the asymmetry of moral norms for borrowers and market norms for lenders gives lenders an unfair advantage in negotiations related to the enforcement of contractual rights and obligations, including the borrower's right to exercise the *put option*. This imbalance is exaggerated by the credit reporting system, which gives lenders the power to threaten borrowers' human worth and social status by damaging their credit scores – scores that serve as much as grades for moral character as they do for creditworthiness.<sup>184</sup> The result is a predictable imbalance in which individual homeowners have born a huge and disproportionate burden of the housing collapse.

## VII. Leveling the Playing Field

While the federal government has given billions to bailout financial institutions, the primary assistance that it has offered to underwater homeowners has been allowing them to refinance up to 125% of their home's current value at "today's lower interest rates"<sup>185</sup> – if they are current on their mortgage and their original loan was insured by Freddie Mac or Fannie Mae.<sup>186</sup> Additionally, for homeowners "at risk of imminent default," the Treasury Department has encouraged lenders to voluntarily modify loans so that borrower payments do not exceed 31% of their total monthly income.<sup>187</sup> In order to incentivize such loan modifications, the Treasury Department has offered lenders \$1,000 for each eligible mortgage they modify, plus \$1,000 per year for three years as long as the borrower remains in the program.<sup>188</sup> Additionally, once the lender has absorbed the cost of reducing the monthly debt-to-income ratio to 38%, the Treasury Department will share the cost, dollar-for-dollar, of reducing the ratio further to 31%.<sup>189</sup>

---

<sup>184</sup> See Rashmi Dyal-Chand, *Human Worth as Collateral*, 38 RUTGERS L.J. 793 (2007)

<sup>185</sup> Press Release, HUD, Sec'y Donovan Announces Expanded Eligibility For Making Home Affordable Refinancing (Jul.y1, 2009), available at <http://www.hud.gov/news/release.cfm?content=pr09-104.cfm>.

<sup>186</sup> *Id.*

<sup>187</sup> See Press Release, Dep't Treasury, Making Home Affordable: Updated Detailed Program Description (Mar. 4, 2009) available at [http://www.treas.gov/press/releases/reports/housing\\_fact\\_sheet.pdf](http://www.treas.gov/press/releases/reports/housing_fact_sheet.pdf).

<sup>188</sup> *See id.*

<sup>189</sup> *Id.*

Government policy makers have premised this approach on two central tenants: (1) that the key to preventing foreclosures is to ensure that mortgage payments are affordable; and (2) that the severity of the foreclosure crisis in the United States is due in large part to lenders unwillingness to renegotiate mortgages to make them more affordable.<sup>190</sup> Policy makers have grounded this single-minded focus on affordability upon studies from earlier, less severe, housing busts that showed that borrowers with affordable mortgages rarely default.<sup>191</sup>

There are several problems, however, with focusing on affordability alone as the key to averting the worsening of the foreclosure crisis. First, government programs have defined “unaffordable” as a total monthly payment exceeding 30% of one’s gross monthly income.<sup>192</sup> This arbitrary cut off does not account for the reality that even if one’s payment doesn’t exceed 30% of gross monthly income, paying - for example - \$3000 a month for a home that could be purchased or rented today for around \$1000 a month is financially unwise. Or as “an economist might argue ... an unaffordable mortgage is one that is really too expensive, in the sense that the benefits that come with making payments on the mortgage no longer outweigh the opportunity costs of doing so.”<sup>193</sup> To account for this fact, “affordable” might instead be defined not only according to one’s grossly income, but also in relation to the fair rental value of one’s home. A home that cost three times more to own than it would to rent is by definition unaffordable. On the other hand, a home that cost less to own than it would to rent might be not too expensive even if the payment exceeds 30% of one’s gross monthly income, as long as one could make the payment with room to spare.

Conversely, paying 30% of gross monthly income to a mortgage will leave many middle-to-low-income individuals with little to spare – especially to the extent that individuals have other significant financial obligations such as child care or medical bills. Indeed, leaving aside monthly budget concerns, 30% (or even 20%) of one’s income is a significant percentage if the payment is essentially being thrown away into a large negative equity hole out from which one is not likely to dig. Once a home has become an albatross instead of an investment, struggling to pay a mortgage makes no financial sense, almost regardless of one’s monthly payment. Thus, as Gusio, Sapienza, and Zingales have shown, for

---

<sup>190</sup> Adelino, Gerardi, & Willen, *supra* note 165.

<sup>191</sup> Guiso et al., *supra* note 11, at 21

<sup>192</sup> See HUD, Affordable Housing, <http://www.hud.gov/offices/cpd/affordablehousing/index.cfm> (last visited Oct. 6, 2009) (stating, “The generally accepted definition of affordability is for a household to pay no more than 30 percent of its annual income on housing.”).

<sup>193</sup> See Foote, et. al, *supra* note 70 at 4.

many homeowners technical affordability is not the lone consideration. Relative affordability and negative equity both matter as well – and once negative equity is severe enough, it may overwhelm other considerations.

Recognizing this reality, number of proposals have been put forth to address the relative affordability and/or negative equity problem. Joseph Stiglitz has suggested, for example, that the government should itself become a lender and issue mortgages at low interest rates, which would help address the relative affordability issue and partially compensate for negative equity.<sup>194</sup> Others have suggested that the government use stimulus funds to buy down underwater mortgages<sup>195</sup> or assist homeowners through grants that would cover a portion of their payments.<sup>196</sup> Each of these proposals would bring some balance to the government's current approach to the mortgage crisis by providing direct assistance to homeowners as opposed to injecting money into the banking system in hopes that some of the benefit will trickle down in the form of greater credit availability. Equally as important, they would circumvent the problems created by norm asymmetry between borrowers and lenders because borrowers could go to the government for help regardless of their lender's willingness to renegotiate.

In contrast to a government bailout of underwater homeowners, others have proposed measures that would force lenders to write off some of the principle of underwater mortgages, without the government picking up the tab. For example, Adam Levitin has proposed allowing bankruptcy judges to write down mortgages by reducing the principle until the outstanding mortgage

---

<sup>194</sup> Stiglitz has argued that such a program would allow the government to earn a return on these mortgages and incentivize the mortgage industry to compete by restructuring loan terms. Memorandum from Joseph E. Stiglitz to The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, 2-3, available at [http://www.un-gls.org/docs/ga/cfr/memo\\_foreclosures.pdf](http://www.un-gls.org/docs/ga/cfr/memo_foreclosures.pdf). However, in order to adequately compensate for negative equity, especially for homeowners who are hundreds of thousands of dollars underwater, interest rates would have to be truly low - as in somewhere around 2-3%.

<sup>195</sup> Rebel A. Cole, The Housing-Asset Relief Program: A Plan for Stabilizing the Housing and Securities Markets (April 22, 2009). Available at SSRN: <http://ssrn.com/abstract=1338883> (proposing that “\$300 billion in TARP or stimulus funds” be “used to write down the principals on underwater mortgages.”)

<sup>196</sup> Christopher L. Foote, et., al., *A Proposal to Help Distressed Homeowners: A Government Payment-Sharing Plan*, FRB of Boston Public Policy Brief No. 09-1 (July 9, 2009), available at SSRN: <http://ssrn.com/abstract=1432514> (proposing a “government payment-sharing arrangement” whereby the government would pay part of the homeowner's existing mortgage, providing a “significant reduction in the homeowner's monthly mortgage payment.”)

does not exceed the home's value.<sup>197</sup> This proposal too is a step in the right direction in that it would effectively compensate for the problems of norm asymmetry by eliminating the need for borrowers to negotiate with lenders. However, the proposal has been criticized for imposing a significant burden on bankruptcy courts and creating the possibility of an unjust windfall for homeowners should prices later appreciate.<sup>198</sup> It would also help only underwater homeowners who could show that they could not "afford" their mortgage payments. It would thus fail to assist many responsible underwater homeowners who did not reach beyond their means, but simply purchased at the wrong time.

In response to these concerns, Eric Posner and Luigi Zingales have suggested changing federal bankruptcy law to allow "prepackaged," or streamlined, mortgage cram-downs under Chapter 13 of the Bankruptcy Code.<sup>199</sup> Under Posner and Zingales' intriguing proposal, any homeowner who lives in a ZIP code where the median home price has dropped by more than 20 percent from its peak would have the right to submit a "Chapter 13 prepack."<sup>200</sup> This prepack "would simply contain a new mortgage amount that is equal to the old mortgage amount discounted by the percentage decline of the median house price for the ZIP code. Monthly payments would decline by the same percentage; the term of the mortgage would not be changed."<sup>201</sup> The creditor would not have the right to oppose the prepack, but would be entitled to a percentage of the home's appreciate upon sale equal to the percentage reduction in the principle pursuant to the prepack.<sup>202</sup>

Like the Levitin proposal, the prepackage bankruptcy would be a positive step in circumventing the barriers to renegotiation caused by norm asymmetry. The prepack also has several advantages to the Levitin proposal, including that it would

---

<sup>197</sup> See Adam Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, (April 24, 2009) Available at SSRN: <http://ssrn.com/abstract=1071931> (arguing for modification of home-mortgage debt in bankruptcy proceedings); See also Eric A. Posner & Luigi Zingales, *The Housing Crisis and Bankruptcy Reform: The Prepackaged Chapter 13 Approach* 21 (School of Business Research Paper No. 09-11; U of Chicago Law & Economics, Olin Working Paper No. 459, February 25, 2009), available at <http://ssrn.com/abstract=1349364>. (discussing similar proposal from Senator Durbin).

<sup>198</sup> Eric A. Posner & Luigi Zingales, *The Housing Crisis and Bankruptcy Reform: The Prepackaged Chapter 13 Approach* 21 (School of Business Research Paper No. 09-11; U of Chicago Law & Economics, Olin Working Paper No. 459, February 25, 2009), available at <http://ssrn.com/abstract=1349364>.

<sup>199</sup> Posner & Zingales, *supra* note , at .

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

impose less of a burden on the courts because the prepackage bankruptcy would be “automated, requiring only a rubber stamp by a bankruptcy judge.”<sup>203</sup> Nevertheless, the prepack proposal has significant drawbacks as well, including that it would intrude ex post into the contractual relationship of private parties and would create additional administrative burdens for already over-burdened bankruptcy courts.<sup>204</sup> It is also a blunt instrument in that it arbitrarily limits cramdowns to ZIP codes where prices have declined 20% and does not account for the often great variation of depreciation within a single ZIP code.<sup>205</sup>

While the Levitin and the Posner and Zingales’ proposals are still worth considering despite any drawbacks, understanding the role of the credit rating system in enforcing norm asymmetry could point to simpler solutions for forcing lenders to renegotiate underwater mortgages with borrowers. One such solution, for example, would be to amend the Fair Credit Reporting Act to prevent lenders from reporting mortgage defaults and foreclosures to credit rating agencies, and to couple this amendment with an extension beyond 2012 of the federal tax waiver on “forgiven” portions of one’s mortgage and a national anti-deficiency statute barring lenders from pursuing homeowners for a mortgage’s unsatisfied portion upon foreclosure.

Though not without controversy, extending the tax waiver and passing an anti-deficiency statute address the underlying economic costs of default to the borrower and should therefore be self-explanatory.<sup>206</sup> The remainder of this article thus focuses on the proposal to amend the Fair Credit Reporting Act to prevent lenders from reporting mortgage defaults and foreclosures to credit rating agencies. To be clear, however, this proposal is not presented here as the only possible solution to the exclusion of all others. Rather it is presented as a jumping off point for further discussion as to how norm asymmetry can be addressed and lenders encouraged to voluntarily renegotiate mortgages. At the very least, it is a useful thought experiment. At the best, it may in

---

<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> The plan would thus be over-inclusive and under-inclusive, allowing some owners a write-down even when their particular neighborhood had not experienced declines exceeding the magical 20% cut off, but denying relief to others who neighborhoods had experienced steep declines, but whose overall ZIP code had fared better than a 20% decline.

<sup>206</sup> See Andra Ghent and Marianna Kudlyak, *Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States*, Federal Reserve Bank of Richmond Working Paper No. 09-10 (July 10, 2009), available at SSRN: <http://ssrn.com/abstract=1432437> (finding that “recourse decreases the probability of default when there is a substantial likelihood that a borrower has negative home equity.”)

fact be the key to eliminating norm asymmetry between lenders and borrowers, forcing a more equitable division of the housing crisis's financial burden, and preventing the foreclosure crisis from spreading to prime loans.

The suggestion that Congress should amend the Fair Credit Reporting Act to prevent lenders from reporting mortgage defaults is premised upon the underlying mortgage contract, in which lenders agree to hold the house alone as collateral. In the case of underwater mortgages, however, the portion of the mortgage above the home's present value essentially becomes unsecured. Lenders compensate for this by holding the borrowers' credit score, and thus their human worth, as collateral – thereby altering the underlining agreement that the home serves as the sole collateral. As a consequence, lenders are often able to reap the benefit, but escape the costs, of their bargain.

Preventing lenders from reporting mortgage defaults to credit rating agencies would, as a practical matter, eliminate lenders' ability to hold borrowers' human worth as collateral. Such a change would also serve as an important signal from the government – sending the message that a borrower who exercises a contractual right to default should not be viewed as immoral or irresponsible. It would thus help considerably in leveling the playing field between lenders and borrowers. With the threat of damage to the borrower's credit score removed, the borrower could more credibly threaten to walk absent a principle reduction. It bears emphasizing, however, that the borrower would be unlikely to bargain “ruthlessly” because, even without the credit reputation hit, there are significant transaction costs to moving and finding a new home.<sup>207</sup> Indeed, because of these costs, and attachment to home,<sup>208</sup> few homeowners would walk at less than 10% negative equity.<sup>209</sup>

Thus, if a mortgage were underwater, for example, by 20%, the lender and homeowner might agree to share equally in absorbing the loss - or a homeowner might agree to absorb all of the negative equity in exchange for a reduction in the interest rate. The parties might also agree to condition any reduction in principle on the lender sharing in future appreciation – in effect converting the mortgage into a shared equity loan. In other words, the lender

---

<sup>207</sup> See ROBERT AVERY ET. AL., *supra* note 145.

<sup>208</sup> Indeed, lenders benefit not only from negative emotions such as guilt and fear, but also positive attachment to the idea of homeownership. This emotional attachment to homeownership is also socially cultivated and been internalized by most Americans, who generally see homeownership as both a good investment and an integral part of the American dream -and thus may cling to their homes when they could walk away, rent something nicer, and put the money they save into an investment with better returns.

<sup>209</sup> Guiso et al., *supra* note 11, at 21.

and homeowner would be free to negotiate a mutually beneficial arrangement to continue the mortgagor-mortgagee relationship, or they could settle for the benefit of their original bargain and the mortgagor could have the house.

Additionally, this approach would have significant advantages over Posner and Zingales' proposal for forced cramdowns. First, it would allow the parties to come to their own mutually agreeable solution to the negative equity problem, without the government intruding into a private contractual relationship and rewriting the contract itself. Second, it allows for nuanced, borrower-specific solutions, rather than across the board treatment for whole ZIP codes, or arbitrary cut-offs based upon a set percentage of the borrower's gross monthly income. Third, it would not require the government to create a new bureaucratic structure or expend any taxpayer money - nor would it impose new regulations on lenders. The proposal simply identifies a distortion in the market created by norm asymmetry and eliminates that distortion. Indeed, the proposal to eliminate the credit threat is, at heart, a market-based solution. It should thus be preferable to a government bailout of homeowners or a government take-over of the lending industry.<sup>210</sup> By the same token, it should be attractive to consumer advocates in that it protects the credit of underwater homeowners and gives them more leverage to negotiate.<sup>211</sup>

Nevertheless, some might still object that eliminating the credit threat would encourage default among underwater homeowners.<sup>212</sup> But that is, in part, the point: in an environment

---

<sup>210</sup> The proposal is, of course, not likely to satisfy those that believe homeowners have a moral obligation to pay their mortgage regardless of whether it would be more efficient to breach. Nor, it goes without saying, is the proposal going to be welcomed by the lending industry.

<sup>211</sup> There is already a large and growing industry devoted to helping underwater homeowners negotiate write-downs with lenders. As evidence of the size of this industry, there have been "massive numbers of complaints" in California against lawyers who have taken fees to renegotiate mortgages and have failed to deliver. Jim Wasserman, *Loan modification firms banned from demanding upfront fees*, SACRAMENTO BEE, 6B, Oct. 13, 2009. As a result, lawmakers in California passed legislation to bar up-front fees for mortgage renegotiation services. See *Advanced Fees For Loan Modification are now Illegal in California*, California Department of Real Estate. Available at [http://www.dre.ca.gov/pdf\\_docs/FraudWarningsCaDRE03\\_2009.pdf](http://www.dre.ca.gov/pdf_docs/FraudWarningsCaDRE03_2009.pdf) It thus seems fair to say that eliminating the credit threat would - at a minimum - help the thousands of people who are already trying to negotiate with their lenders, but find they have little leverage unless they are willing signal their willingness to walk by missing payments and sacrificing their credit scores.

<sup>212</sup> Rather than objecting that eliminating the credit threat would encourage default among underwater homeowners, others are likely to argue the opposite: namely, that eliminating the credit threat would do nothing to alter homeowner behavior. This objection would be grounded upon surveys that have shown that many people don't understand what a credit score is, much less care

where there was less stigma attached to default and where homeowners could more credibly threaten to walk away, lenders would be more willing to negotiate with underwater homeowners. The end result would paradoxically be fewer defaults - as homeowners would not feel compelled - or be told - to default before the lender would negotiate. Moreover, even if there were

---

about their own. See, Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008)(arguing that “survey evidence also suggests that “[m]ost consumers do not understand what credit scores measure, what good and bad scores are, and how scores can be improved.”) However, credit knowledge surveys have not isolated people with high credit scores to see what they know or how they feel about credit scores (and, as discussed above, 94% of people with prime loans have high credit scores). This subset of the population with high credit scores likely cares more and know more about credit scores than the general population. Moreover, despite headlines to the contrary, credit knowledge surveys have actually shown that a very significant portion of the population does in fact understand the importance of good credit, care about their credit scores, and understand the basics of credit reporting. See e.g., *Press Release, Consumer Fed'n of Am. & Providian, Most Consumers Do Not Understand Credit Scores According to a New Comprehensive Survey 1* (2004), available at <http://www.consumerfed.org/pdfs/092104creditscores.pdf> (concluding that “most consumers don’t understand credit scores” despite finding that “most customers correctly understand that lenders use credit scores,” 34% correctly understand that credit scores measure credit risk, 35% understand that credit scores are unrelated to income, and 60% correctly understand how to improve their credit score); *Poll: Consumers Don't Understand Credit Reporting, Favor Reforms*, Ins. J., Aug. 11, 2003, <http://www.insurancejournal.com/news/national/2003/08/11/31410.htm> (finding that consumers don’t understand many specifics of credit reporting, but finding that 97% understand that they have the right to see their credit report, 81% know that consumers who fail to qualify for a loan have the right to a free credit report, 46% understand that in most states they must pay a fee to obtain their credit report, 45% understand that their credit score may be lowered if they use all of the credit available on their credit card, and that 73% understand that their credit score measures their credit-worthiness.); *Survey: 27% of Consumers Do Not Read Credit Reports*, *Credit & Collections World*, Oct. 5, 2006, <http://creditandcollectionsworld.com/article.html?id=20061016NIJPR6OI> (finding that 73% of individuals have at some point checked their credit score); *Scores & Jobs*, *CardFlash*, Sept. 14, 2007, <http://www.cardweb.com/cardflash/2007/09/14/scores-jobs> (finding that 60% of individuals had checked their credit score and that a full 22% of respondents check their credit score every year); U.S. Gov't Accountability Office, *Credit Reporting Literacy: Consumers Understood the Basics but Could Benefit from Targeted Educational Efforts 10-11* (2005), available at <http://www.gao.gov/new.items/d05223.pdf> (reporting that 70% of respondents correctly defined a credit score). Individuals who care about and understand their credit score likely constitute a much more significant portion of people with prime loans (with is only subset of individuals about which this proposal is concerned) than the general population. Moreover, one does not really need to understand much about one’s credit score to not want to mess it up - and even the most ignorant homeowner likely knows a foreclosure will hurt his credit. It thus makes sense that removing the credit threat would alter the behavior of at least a significant minority of underwater homeowners.

more initial defaults, fewer of these defaults would end in foreclosures - as a missed payment would signal the homeowner's seriousness to the lender and bring the lender more quickly to the table. This would stand in sharp contrast to the current environment where lenders often have an economic incentive not to work with borrowers, on the theory that the vast majority of those who threaten to default will not follow through and that modifying mortgages of underwater homeowners will simply encourage more defaults.<sup>213</sup>

The proposal's value in forcing lenders to negotiate should not be underestimated. Indeed, "every major policy action to date has involved encouraging lenders, in one way or another, to renegotiate loan terms in order to reduce borrower debt loads." This includes, of course, the Making Home Affordable program, which tries to encourage renegotiation by offering modest financial incentives to lenders. As the paucity of loan modifications under this program attests,<sup>214</sup> however, offering lenders a few thousand dollars to modify delinquent loans does not alter the underlying economic incentives or the lender-borrower dynamic that drives lenders to prefer foreclosure to renegotiation.<sup>215</sup> Voluntary renegotiation of home mortgages has remained the elusive "public policy holy grail."<sup>216</sup> This failure to effectively encourage voluntary renegotiation has stemmed - at least in part - from policy makers' failure to appreciate the role of norm asymmetry in lenders' unwillingness to negotiate with borrowers (at least not until borrowers have shown their willingness to sacrifice their

---

<sup>213</sup> Even a relatively modest increase in the number of credible threats of default could alter the economic calculation for lenders that causes them not to renegotiate. Such would be the likely outcome of removing the credit threat - as the signaling function of a late payment would be less costly to borrowers, meaning many more people would default if necessary in order to bring lenders to the table. But, it should be emphasized that the increase in defaults would likely be temporary - as lenders would soon comprehend that it would be less costly to negotiate with borrowers who threaten default before they actually stop making payment.

<sup>214</sup> Though the Treasury Department predicted that these programs would offer assistance to 7 to 9 million homeowners, only 360,165 loan modifications had taken place under the program as of August 31, 2009. Financial Stability, Making Home Affordable Program: Servicer Performance Report through August 2009, [http://www.financialstability.gov/docs/MHA-Public\\_090909.pdf](http://www.financialstability.gov/docs/MHA-Public_090909.pdf) (last visited Oct. 10, 2009).

<sup>215</sup> *Id.* (noting, "No matter which definition of renegotiation we use, one message is quite clear: lenders rarely renegotiate. Fewer than 3 percent of the seriously delinquent borrowers in our sample received a concessionary modification in the year following the first serious delinquency.")

<sup>216</sup> Manuel Adelino, Kristopher Gerardi, & Paul Willen, *supra* note 165 (noting "there is a consensus among many observers that concessionary modifications are the most, or possibly the only, effective way of preventing foreclosures.")

credit scores). Eliminating the credit threat may thus, in fact, be part of the key to unlocking the holy grail of voluntary renegotiation.

Despite these benefits, one might still object to the proposal on the theory that the lender's ability to collateralize borrowers' credit scores reduces risk to the lender, thereby allowing them to offer lower interest rates.<sup>217</sup> Thus, the argument would go, eliminating the credit threat would increase borrowers' lending costs and restrict credit. At the outset, it bears noting that this is the typical argument against most consumer protections – and that similar arguments can be expected against *any* proposal that would effectively shift some of the burden of underwater mortgages off homeowners and onto lenders.<sup>218</sup> Indeed, the same arguments about increased interest rates and restricted credit have been made in opposing mortgage cramdowns – though recent empirical work by Adam Levitin and Joshua Goodman has suggested that permitting bankruptcy modification of mortgages would have little to no impact on mortgage markets.<sup>219</sup> Predictions of high interest rates and restricted credit should thus be approached with a healthy bit of skepticism.

Moreover, any possible costs of eliminating the credit threat should be weighed against the potentially enormous benefit

---

<sup>217</sup> Relatedly, others might argue that barring the reporting of mortgage defaults would reduce the utility of the credit reporting system in providing information about the reliability of potential borrowers. This is true only if one assumes that the same information about borrowers is relevant for secured verses unsecured debt. However, it would seem that secured debt, such as home mortgages, should operate in a different sphere than unsecured debt – where in fact the only collateral the lender has is the borrowers' credit score. See Avery, *supra* note [x] (discussing separate risk assessment model that already exists for home mortgages)

<sup>218</sup> See Posner & Zingales, *supra* note [x], at [x]. (noting that “[t]he financial industry opposes any loan modification because it will increase the future cost of credit and reduce its availability.”)

<sup>219</sup> Adam Levitin and Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets*, Georgetown Law and Economics Research Paper No. 1087816 (February 6, 2008), available at SSRN: <http://ssrn.com/abstract=1087816> (arguing that current and historical data suggests that permitting bankruptcy modification of mortgages would have no or little impact on mortgage markets, including mortgage interest rates); and Adam Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, (April 24, 2009) Available at SSRN:<http://ssrn.com/abstract=1071931> (arguing that “permitting modification would have little or no impact on mortgage credit cost or availability.”); See also Adam Levitin, *A Critique of the American Bankers Association's Study on Credit Card Regulation*, Georgetown Law and Economics Research Paper No. 1029191; Georgetown Public Law Research Paper No. 1029191 (August 18, 2008) Available at SSRN: <http://ssrn.com/abstract=1029191> (disputing contention by American Bankers Association that credit card regulation increases interest rates).

of empowering homeowners to more successfully negotiate away their negative equity. First, numerous studies have shown that negative home equity reduces consumer spending: the higher the incidence of negative equity in the housing market, the weaker aggregate demand in the overall economy.<sup>220</sup> Second, negative home equity is associated with drastically reduced household mobility,<sup>221</sup> which has a range of negative macroeconomic effects, including increased structural unemployment, reduced productivity, and limited the supply capacity.<sup>222</sup> Empowering homeowners to reduce their negative equity through renegotiation could thus have enormous economic benefit in its own right.

---

<sup>220</sup> See Tomas Hellebrandt, et. al., *The Economics and Estimation of Negative Equity*, BANK OF ENGLAND QUARTERLY BULLETIN 2009 Q2 (June 12, 2009)(arguing that “A rising incidence of negative equity is often associated with weak aggregate demand.”); M. Corder and N. Roberts (2008), ‘Understanding dwellings investment’, 48 BANK OF ENGLAND QUARTERLY BULLETIN 393 (indicating that negative equity reduces the incentive for homebuilders and homeowners to invest in housing) A. Benito, et. al., *House prices and durables spending*, BANK OF ENGLAND QUARTERLY BULLETIN 142–54 (Summer 2006)(showing that negative equity negatively affects aggregate consumer spending); Benito, A and Mumtaz, H (2006), *Consumption excess sensitivity, liquidity constraints and the collateral role of housing*, Bank of England Working Paper No. 306. (2008) (negative equity raises the probability of a household being credit constrained and thus unable to purchase); R. Disney, et. al., *House price shocks, negative equity and household consumption in the United Kingdom*, JOURNAL OF EUROPEAN ECONOMIC ASSOCIATION (forthcoming 2008)(negative equity leads to greater savings and lower spending.); and *Drowning in Debt*, *supra* note 6 at 16 (noting that negative equity suppresses middle class consumption)

<sup>221</sup> See Tomas Hellebrandt, et. al., *The Economics and Estimation of Negative Equity*, BANK OF ENGLAND QUARTERLY BULLETIN 2009 Q2 (June 12, 2009) (indicating that “Negative equity can affect household mobility by discouraging or restricting households from moving house); A Tversky and D. Kahneman, *Loss aversion in riskless choice: a reference-dependent model*, 106 THE QUARTERLY JOURNAL OF ECONOMICS 1039 (1991), (indicating that individuals are reluctant to move because they do not wish to take a loss on their home); and A. Henley, *Residential mobility, housing equity and the labour market*, 108 ECONOMIC JOURNAL 414 (1998), (finding that twice as many individuals many would have moved in the early 1990’s in England had they not been in negative equity); and Fernando V. Ferreira, et. al., *Housing Busts and Household Mobility* NBER Working Paper Series (September 2008), available at SSRN: <http://ssrn.com/abstract=1264572> (discussing the correlation between decreased household mobility and negative equity). See also Louis Uchitelle, *Unsold Homes Tie Down Would-Be Transplants*, N.Y. TIMES, Apr. 3, 2008 (noting, “The rapid decline in housing prices is distorting the normal workings of the American labor market. Mobility opens up job opportunities, allowing workers to go where they are most needed.” Also noting that labor mobility that has been seriously hindered by the housing crisis).

<sup>222</sup> See A. Henley, *Residential mobility, housing equity and the labour market*, 108 ECONOMIC JOURNAL 414 (1998) and Tomas Hellebrandt, et. al., *The Economics and Estimation of Negative Equity*, BANK OF ENGLAND QUARTERLY BULLETIN 2009 Q2 (June 12, 2009).

Moreover, barring the reporting of mortgage defaults could have positive effects on future lender behavior. This is because in the case of a home mortgage, the lender has the ability to ensure that the collateral is sufficient to create the proper economic incentives for borrowers not to default. In other words, they need not rely upon credit scores to control their risk, but can instead ensure that the purchase price of the financed home is in line with historically sustainable price-to-rent ratios, demand sufficient down payment and eschew interest-only and negative amortization loans.<sup>223</sup> Lenders would be more inclined to take these sensible precautions if borrowers were empowered to behave according to the same market norms as lenders and breach when it is efficient to do so. This added caution by lenders might in turn help avoid a repeat of the current housing crisis.

The above proposal should not, however, obscure the broader point: norm asymmetry between borrowers and lenders creates disincentives for lenders to renegotiate underwater mortgages and makes it unlikely that lenders will work with borrowers to address the negative equity issue. Any proposal to address the problems created by negative equity must account for this reality – though there is no one right way to accomplish this goal. Viable approaches could include: (1) cutting lenders out of the picture altogether through government financing of mortgages at low interest rates; (2) using stimulus funds to buy down the mortgages of underwater homeowners;<sup>224</sup> (3) forcing lenders to reduce mortgage balances by court order; or (4) leveling the playing field by eliminating the ability of lenders to trash a borrower's credit score in retaliation for the borrower's exercise of his contractual right to default.<sup>225</sup> While each approach would, in effect, address the problems caused norm asymmetry, only eliminating the credit threat does so directly. Eliminating the credit threat also holds significant promise if the goal is also to encourage voluntary renegotiation of mortgages and thereby avoid intrusive and costly government intervention.

---

<sup>223</sup> Moreover, to the extent that a mortgage default is relevant to a credit application, lenders could ask and borrowers could be required to disclose that information – as borrowers are now required to do even when the default is no longer reflected in their credit score.

<sup>224</sup> See Rebel A/ Cole, *The Housing-Asset Relief Program: A Plan for Stabilizing the Housing and Securities Markets* (April 22, 2009). Available at SSRN: <http://ssrn.com/abstract=1338883> (proposing that “\$300 billion in TARP or stimulus funds” be “used to write down the principals on underwater mortgages.”)

<sup>225</sup> This limit on credit reporting should also, as discussed above, be combined with a national anti-deficiency statute and an extension of the tax waiver for forgiven mortgage debt.

## Underwater and Not Walking Away

Regardless of the precise policy prescription, it is time to put to rest the assumption that a borrower who exercises the option to default is somehow immoral or irresponsible. To the contrary, walking away may be the most financially responsible choice if it allows one to meet one's unsecured credit obligations or provide for the future economic stability of one's family. Individuals should not be artificially discouraged on the basis of "morality" from making financially prudent decisions, particularly when the party on the other side is amorally operating according to market norms and could have acted to protect itself by following prudent underwriting practices. The current housing bust should be viewed for what it is: a market failure – not a moral failure on the part of American homeowners. That being the case, it is time to take morals out of the picture and search for an equitable solution to the negative equity problem.