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WHEN HOMEOWNERS WALK AWAY: NEW RESEARCH REVEALS MORE THAN 25 PERCENT OF MORTGAGE LOAN DEFAULTS ARE STRATEGIC

Financial Trust Index Researchers
Study Economic and Moral Factors In Strategic Default

CHICAGO (June 26, 2009) – While the Obama administration's housing policy has been largely influenced by a study of the Boston housing market during the 1990-91 recession in which homes devalued by approximately 10 percent, new research suggests that a novel phenomenon is at hand in the fallout of today's more severe housing crisis – strategic default on mortgage loans. Given that homes in numerous parts of the country have lost more than 30 to 40 percent of their value, many homeowners say they would simply walk away from their loans – without fear of repercussion.

A new paper, entitled "Moral and Social Restraints to Strategic Default on Mortgages," looks at American homeowners' propensity to default when the value of a mortgage exceeds the value of their house, even if they can afford to pay their mortgage. By using new survey data, the paper estimates that more than a quarter of defaults on mortgage loans are strategic, especially when home values have fallen by more than 15 percent.

The new research was led by Paola Sapienza (Kellogg School of Management at Northwestern University) and Luigi Zingales (University of Chicago Booth School of Business) – co-authors of the quarterly Chicago Booth/Kellogg School Financial Trust Index – as well as Luigi Guiso (European University Institute). With data collected from surveys conducted within the last six months as part of the Financial Trust Index, this paper is the first to examine the economic and moral implications of strategic default in the current recession.

Negative Equity

The study of the Massachusetts housing market during the 1990-91 recession found that very few people who could afford their mortgage chose to walk away from their homes. Consistent with the earlier paper, this new research shows that homeowners refrain from defaulting as long as negative equity does not exceed 10 percent of the value of the home.

After that level, however, the researchers found that homeowners start to default at an increasing pace, and walk away massively after decreases of 15 percent and more. In fact, 17 percent of households would default, even if they can afford to pay their mortgage, when the equity shortfall reaches 50 percent of the value of the house.

"Housing policy under the current administration has focused on reducing households' cash flow problems in response to the housing crisis, but no one has addressed the negative equity issue as part of public policy regarding housing," said Sapienza "We're in a completely different economic environment today, where for the first time since the Great Depression millions of Americans have mortgage loans that exceed the value of their home."

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Moral and Social Factors in Strategic Default
According to the researchers, moral and social variables play a significant role in predicting strategic default. People surveyed who said it was immoral to default were 77 percent less likely to declare their intention to do so, while people who know someone who defaulted were 82 percent more likely to say they would default themselves.

"The most important barriers to strategic default seem to be both moral and social," said Zingales. "Our research showed there is a 'multiplication effect,' where the social pressure not to default is weakened when homeowners live in areas of high frequency of foreclosures or know others who defaulted strategically. In fact, the predisposition to default increases with the number of foreclosures in the same ZIP code."

"Factors such as age, location, political affiliation and attitudes toward government intervention also impacted respondents' responses to the morality of strategic default," he added.

Specifically, the researchers highlighted the following data:

- People under the age of 35 and over the age of 65 were less likely to say it was morally wrong to default compared to middle-aged respondents.
- People with a higher education (eight percentage points) and African-Americans (14 percentage points) are less likely to think it is morally wrong to default, whereas respondents with a higher income are more likely to think it is morally wrong.
- Default is considered less morally wrong in the U.S. Northeast (six percentage points) and West (8½ percentage points).
- There was little difference in the moral view of strategic default among Republicans and Democrats, but Independents were less likely to say defaulting is immoral.
- Respondents who supported government intervention to help homeowners were 12 percentage points less likely to say strategic default is immoral.

"As defaults become more common, the social stigma attached with defaulting will likely be reduced, especially if there continues to be few repercussions for people who walk away from their loans," concluded Sapienza. "This has an adverse effect on homeowners who do pay their mortgages, and the after-effects of more defaults and more price collapse could be economic catastrophe."

ABOUT THE SURVEY: On a quarterly basis, the Financial Trust Index captures the amount of trust Americans have in the private institutions in which they can invest their money. The survey is conducted by Social Science Research Solutions (SSRS) using ICR's weekly telephone omnibus service. To assess the frequency and determinants of strategic default, the researchers included variables in surveys conducted with more than 1,000 individuals over two two-week periods in December 2008 and March 2009.
MORE INFORMATION: To learn more about the key findings in "Moral and Social Restraints to Strategic Default on Mortgages," or to learn about the Chicago Booth/Kellogg School Financial Trust Index, visit www.financialtrustindex.org. To arrange an interview, contact Meg Washburn or Allan Friedman at the contact information listed above.

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