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Debtor's Dilemma: Pay the Mortgage or Walk Away

In Down Real-Estate Market, Homeowners Are Deciding to Abandon Their Loan Obligations Even if They Can Afford the Payments

By JAMES R. HAGERTY and NICK TIMIRAOS

PHOENIX -- Should I stay or should I go? That is the question more Americans are asking as the housing market continues to drag.

In good times, it would have been unthinkable to stop paying the mortgage. But for Derek Figg, a 30-year-old software engineer, it now seems like the best option.

Mr. Figg felt trapped in a home he bought two years ago in the Phoenix suburb of Tempe for $340,000. He still owes about $318,000 but figures the home's value has dropped to $230,000 or less. After agonizing over the pros and cons, he decided recently to stop making loan payments, even though he can afford them.

Mr. Figg plans to rent an apartment nearby, saving about $700 a month.

A growing number of people in Arizona, California, Florida and Nevada, where home prices have plunged, are considering what is known as a "strategic default," walking away from their mortgages not out of necessity but because they believe it is in their best financial interests.

A standard mortgage-loan document reads, "I promise to pay" the amount borrowed plus interest, and some people say that promise should remain good even if it is no longer convenient.

George Brenkert, a professor of business ethics at Georgetown University, says borrowers who can pay -- and weren't deceived by the lender about the nature of the loan -- have a moral responsibility to keep paying. It would be disastrous for the economy if Americans concluded they were free to walk away from such commitments, he says.

Walking away isn't risk-free. A foreclosure stays on a consumer's credit record for seven years and can send a credit score (based on a scale of 300 to 850) plunging by as much as 160 points, according to Fair Isaac Corp., which provides tools for analyzing credit records. A lower credit score means auto and other loans are likely to come with much higher interest rates, and credit card issuers may charge more interest or refuse to issue a card.

In addition, many states give lenders varying degrees of scope to seize bank deposits, cars or other assets of people who default on mortgages.

Even so, in neighborhoods with high concentrations of foreclosures, "it's going to be really difficult to prevent a cascade effect" as one strategic default emboldens others to take that drastic step, says Paola Sapienza, a professor of finance at Northwestern University. A study by researchers at Northwestern and the University of Chicago found that as many as one in four defaults may be strategic.

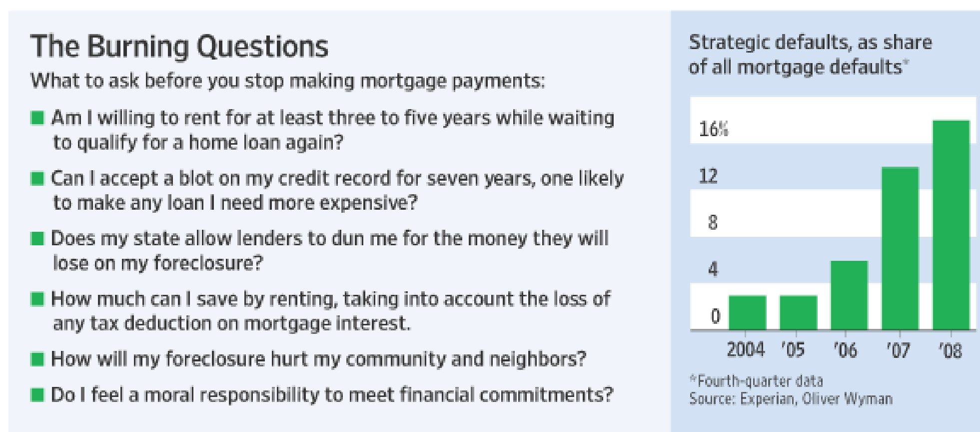
Driving this phenomenon is the rising number of households that are deeply "under water," owing much more than the current value of their homes. First American CoreLogic, a real-estate information company, estimates

that 5.3 million U.S. households have mortgage balances at least 20% higher than their homes' value, and 2.2 million of those households are at least 50% under water. The problem is concentrated in Arizona, California, Florida, Michigan and Nevada.

Josh Cotner, who owns an insurance agency, says his mortgage balance is about $100,000 more than the market value of his home in Gilbert, Ariz. Mr. Cotner could rent a bigger home nearby for $600 a month, far below the $1,655 he now pays on his mortgage, home insurance and property tax. He says he recently stopped making mortgage payments because his lender wouldn't help him reduce the principal on his loan under a federal program in which he believes he is qualified to participate. Given the sometimes lengthy legal process of foreclosure, he may be able to stay in the home for at least another nine months without making any payments.

Banks warn they may get tough with strategic defaulters by pursuing legal claims on a borrower's other assets. "We will try to reduce people's payments if they have a hardship," says Thomas Kelly, a spokesman for J.P. Morgan Chase & Co. "But we have a financial responsibility to get people to pay what they owe if they can afford it."

Steven Olson, a loan officer and roof installer in Roseville, Minn., defaulted in 2007 on a plot of land in Florida he had bought as an investment. "I thought I could move on with my life," he says. But the lender, RBC Bank, a subsidiary of Royal Bank of Canada, sued him, seeking to make him pay more than $400,000 to the bank to cover its losses on the loan. Mr. Olson has hired a Florida lawyer, Roy Oppenheim, to resist the claim. An RBC spokesman declined to comment.



States where lenders generally can pursue such legal claims include Florida and Nevada but not California and Arizona, where laws generally prohibit lenders from pursuing other assets of mortgage borrowers. A new Nevada law will protect many borrowers from these judgments if they bought a home for their own use after Sept. 30, 2009.

Another risk for defaulters is that banks could sell the rights to pursue claims to collection agencies or other firms, which could then dun the borrowers for up to 20 years after a foreclosure. Such threats appear to deter some borrowers. A recent study from the Federal Reserve Bank of Richmond found that under-water borrowers were 20% more likely to default in a state where mortgage lenders can't pursue claims on other assets than in those where they can.

Brent White, an associate law professor at the University of Arizona who has written about this issue, says homeowners should make the decision on whether to keep paying based on their own interests, "unclouded by unnecessary guilt or shame." He says borrowers can take a cue from lenders that "ruthlessly seek to maximize profits or minimize losses irrespective of concerns of morality or social responsibility."

But it isn't just a matter of the borrower's personal interest, says John Courson, chief executive of the Mortgage Bankers Association, a trade group. Defaults hurt neighborhoods by lowering property values, he says, adding: "What about the message they will send to their family and their kids and their friends?"

In Mesa, another suburb of Phoenix, low prices are helping to draw buyers who may walk away from other homes. Christina Delapp bought a house out of foreclosure in July for $49,000 in cash. She says she will stop

paying the mortgage on another home she still owns in Tempe if she can't sell in the next few months for more than the $312,000 that she owes.

Ms. Delapp, who has been jobless for 18 months, says that the new home is part of her survival strategy. "I feel very fortunate," she says. "Regardless of what happens to my credit, we've managed to put together the best safety plan that I possibly could."

Mr. Figg says that deciding to default on his loan was "the toughest decision I ever made." He worried that if he ever loses his job he would be marooned in a home that he couldn't sell for enough to pay off his loan, limiting his ability to find work in other parts of the country: "I couldn't move up. I couldn't move down. I couldn't move out of the city. It was a very claustrophobic situation."

By moving to an apartment, Mr. Figg expects to lower his costs by about $700 a month. He plans to put that into his savings account and says he is willing to rent for the next five years or so.

Lenders are guilty of having "manipulated" the housing market during the boom by accepting dubious appraisals, Mr. Figg says. "When I weighed everything," he says, "I was able to sleep at night."

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