

## **Strategic defaults on homes on the rise**

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Jose and Anna Tolentino moved into their Novato condo in August 2005, two days before Jose, a Navy reservist, shipped out to Kuwait.

"I was happy to have my wife in such a nice place while I was away," he said.

But now, with the condo worth about half the \$425,000 they paid, his attitude has changed.

"I don't want to keep on paying when the house will never go back up to its value," he said. "It's better to cut our losses, get out of there and go rent."

The number of people similarly choosing to cut their losses on their homes continues to rise. Studies estimate about one-quarter of all defaults are voluntary "walkaways," also known as strategic defaults and jingle mail (for the sound the abandoned keys make in a mailbox).

The phenomenon reflects shifting attitudes toward debt and commitment. In an era where high-profile investors have walked away from multibillion-dollar real estate projects and more than 2 million Americans have gone through foreclosure, defaulting has begun to lose its stigma.

Being underwater - owing more than a home is worth - is a big trigger for those strategic defaults. Often another problem, such as job loss, divorce or higher monthly payments, is involved. But some homeowners just don't want to be saddled with a huge mortgage when they have no equity.

### **'Want to start a family'**

"We could make our payment every month by doing a little bit of overtime," said Jose Tolentino. "But we want to start a family. We could rent for half what we're paying and afford to have kids."

The Tolentinos continue to live in the condo, but they stopped paying their mortgage in August, and it is slated for foreclosure this month.

Of all U.S. mortgage holders, about one quarter, or 11.3 million households, are underwater, according to First American CoreLogic, which collects and analyzes mortgage data. In California, 35 percent of mortgage holders are underwater.

"Negative equity gives you the universe of homeowners who are vulnerable to default," said Sam Khater, First American senior economist.

In the Bay Area, First American shows the Vallejo-Fairfield metropolitan market (essentially Solano County) with 61 percent of mortgage holders underwater. The next-highest concentration - but the biggest in numbers - is the Oakland-Fremont-Hayward metro area (Alameda and Contra Costa counties), where 35 percent of mortgage holders, or 192,726 households, have negative equity.

First American said a tipping point seems to come when homeowners have negative equity of 25 percent or more - owing \$500,000 on a \$400,000 house, for instance. At that point, owner-occupants default as frequently as investors.

"The reality is, if you're 30 percent underwater, you're effectively going to be a renter in that home while paying your mortgage for the next 10 to 15 years before you get back to break-even with your equity," said Paul Leonard, director of the California office for the Center for Responsible Lending.

### **Foreclosure not inevitable**

Not all strategic defaults result in foreclosure. If homeowners say they want out, banks typically encourage them to market their property as a short sale (selling for less than what is owed on the mortgage).

TransUnion, a credit reporting company, noticed a striking change in recent months: People who pay their auto loans and credit cards, but not their mortgages. In the past, the "payment hierarchy" always showed people putting their mortgage first.

Why the shift? "We're finding that consumers who are upside down on a mortgage, when they encounter adverse circumstances are less likely to make a rather large payment on a home that is not worth what it was when they (bought it)." said FJ Guarrera, vice president of TransUnion's financial services division.

Counselors who work with troubled borrowers said they see more choosing to give up on their homes.

"Some people watch their home value plummet during the many months they spend negotiating a modification with a servicer," said Maeve Elise Brown, executive director of Housing and Economic Rights Advocates in Oakland. "They get more desperate and depressed. The longer servicers leave people hanging and don't finalize modifications of people who genuinely qualify under HAMP (the government's Home Affordable Modification Program), the more walkaways we'll see."

Brent White, a law professor at the University of Arizona, says that the number of true strategic defaults - people walking away from underwater homes in the absence of other problems such as job loss - seems lower than common sense would dictate.

### **'Good money after bad'**

"People are acting against their own economic self-interest by continuing to pay off houses where they may not have any equity for decades," he said. "They're throwing away good money after bad."

Shame, guilt and fear stop many homeowners from reneging on their mortgages, he said. The government and big banks actively cultivate those emotional constraints because the economic consequences of a large-scale walkaway phenomenon could be dire, he said.

Strategic defaults have widespread repercussions. Ongoing foreclosures destabilize the housing market because the homes are sold at bargain prices. They also undermine the entire economy because banks must eat huge losses and homeowners rein in spending as their own homes lose value. Empty homes hurt neighborhoods and attract blight. And walkaways may inspire copycats - people who've seen their neighbors deliberately default feel more emboldened to do so themselves.

California is a nonrecourse state, where lenders cannot pursue homeowners for the unpaid balance on their first mortgage.

### **'Lender's worst nightmare'**

"In some ways, walking away is the lender's worst nightmare," Leonard said. "While we're certainly not encouraging this, if the numbers were to grow substantially, it

would provide leverage to get servicers to be more proactive in offering modifications, particularly principal-balance reductions."

Lenders are loath to cut principal, which would put mortgages in line with current home values.

"HAMP can't be as successful as we would like because people are deeply underwater," Leonard said. "It's not enough to have affordable (monthly payments) if a borrower can walk across the street and rent some place for less, save money and have a little nest egg by the time their credit score recovers to be able to buy a home."

### Underwater in the Bay Area

Owing more than your home is worth - called being underwater - is often a precursor to foreclosure. Some underwater homeowners walk away from their mortgages because it will take them years to gain any equity; others end up losing their home if something else happens, such as job loss, divorce or higher monthly payments. Homeowners who are underwater by 25 percent or more - owing \$500,000 on a \$400,000 house, for instance - default at rates similar to investors, so this seems to be a tipping point.