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Strategic Default: Inconceivable Assumptions Suddenly Conceivable

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Until recently it was generally believed that only a small fraction of Americans would willingly choose to skip their monthly mortgage payment, aka "strategically default", when they found themselves stuck in a negative equity situation.

The logic driving this belief was based on the notion that borrowers wouldn't want to damage their credit profile or deal with the social stigma surrounding a public foreclosure. The assumption that most underwater borrowers will continue making their monthly payments (absent a life event) is factored into the analytics of risk managers, buyers and sellers of mortgage related assets, servicing managers, and regulators across the country.

What if this assumption is wrong? Is that inconceivable?

It wasn't long ago when conventional wisdom convinced us that lenders would never make loans to borrowers that had virtually zero likelihood of being able to pay the loans back. In a 2010 study conducted by the Cato Institute, it was estimated that there were over 27 million Alt-A and subprime loans in the system by mid-2008. That's approximately 50 percent of all loans in the market. Remember when we thought home price would never fall on a national level? Never been done and won't ever happen, right? That assumption was shattered when home values nationally dropped between 30-50% from their peak in 2006, wiping out roughly $7 trillion of home equity in the process.

Fannie Mae recently published it's latest **National Housing Survey** and exposed disturbing patterns and sentiments with American homeowners. For example, 46% of borrowers are "stressed" about their underwater mortgage, up from 11% in June 2010. That's an alarming four-fold increase in three quarters. That statistic becomes even more concerning when viewing the sheer number of borrowers faced with negative equity. At the end of 2010, which doesn't include the home price declines seen in 2011, CoreLogic **estimated** that 11.1 million homes, or 23.1 percent of all homes with a mortgage, were underwater. Think about those two stats this way - every morning, 46% of the estimated 11.1 million underwater borrowers wake up and debate why they should keep paying their monthly mortgage payment. Further weighing on borrowers is that 47% of borrowers surveyed reported higher household expenses than the year before...

From that perspective, it doesn't seem inconceivable that our assumptions might be off base again. Is principal forgiveness the answer?

Probably not, and here's why. Remember how many folks HAMP was supposed to save by giving them new loan terms? The number touted by the administration was over 4 million. In reality, the number is likely to come in around 500-750,000 permanent modifications. Imagine the scenario when a government sponsored principal reduction program is announced. Out of the 11 million underwater borrowers - you'll probably get three times as many borrowers applying for relief. Maybe one tenth of them will actually qualify and be granted a principal reduction. In the meantime, some 20+ million applicants would have stopped making payments to "qualify" or be considered for qualification. How many of them will be able to or even want to get current again after they are turned down?

Like it or not, we have got to find ways to stabilize home prices, reward responsible behavior among existing homeowners, and encourage home buying. I don't see any ideas on the table that would accomplish any of these objectives.... and the effects are starting to show up in data.

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