STRATEGIC DEFAULTS AND THE BORROWERS' CHARACTER

Some see owing as optional

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In The Wall Street Journal the other day I saw an article on how many home owners are underwater on their home mortgages. By a recent Federal Reserve estimate, it's about 12 million, a number exceeding 20% of all home mortgages outstanding. This is not a brand- new problem in the current recession, but its sheer size suggests that it's an issue the economy will wrestle with for a long time to come. While the extent of the problem is unevenly distributed across the country, it's clearly a national issue that is not easily measured nor simply described.

By 2009, the term "strategic default" entered lenders' vocabularies. Strategic defaulters are those who have the capacity to continue paying on their mortgages but have elected not to and have chosen to default on their mortgage payments.

Strategic default's roots

To some, this was a simple business decision. They entered into a deal for the purchase of a home and when the deal didn't work out they walked away. They may have moved out and be renting somewhere else but more than likely they are still in the house, banking the mortgage payments in a savings account and awaiting the formal foreclosure process to begin.

We're not talking here about people who lost their income or their health and can no longer afford the monthly mortgage payment. These are people to whom their purchase of the residence secured by a mortgage is treated as purely a business deal and a one-sided one at that.

What's not particularly clear is what percentage of delinquent mortgages nationally is represented by strategic defaulters. I suspect that the proportion is significant by the publicity that the problem is receiving. The perception of the extent of this issue is likely further complicated by the reputation risk that has ravaged many very large bank mortgage servicers, who are being excoriated for their foreclosure lapses and their real or apparent unwillingness to renegotiate a lowered payment amount.

Strategic default's implications

The problem on a national basis is real and has multiple dimensions. As a person who has spent most of his entire career as a lender, I am interested primarily in how strategic defaults reflect on the character of the mortgagors.

How can we as lenders protect ourselves against such practices?

Will this negatively impact the attitudes of home lenders, banks and thrifts, in years to come?

In other words, will the strategic defaulters cause shrinkage of the availability of mortgage credit as we emerge from the impacts and absorb the multiple lessons of the current recession?

More than anything else, the practice of strategic defaulting throws into sharp profile the character of the borrower. Under the letter of the contract in normal times, the lender gets its principal back plus an agreed upon rate of interest while the borrower is entitled to the benefits of the upside--all of them. This includes both the value of the shelter that the home owner has purchased but also the possibility of price appreciation.

Now find your Nexium

If you agree with me that strategic defaults reflect a defect in a borrower's character, then Google the subject and see how angry you can become. There are pages of consultants including both law firms and sole practitioners selling services on how to be a strategic defaulter. What is particularly infuriating to me are the stated attitudes on how this activity is just a "business deal."

Here's an example of one web page:

Q: "But Don't I Have a Moral Obligation to Keep Paying?"

A: There is no single answer to this question, but it's safe to say that in most cases, the answer is "No, you don't have a moral obligation, and it's okay to walk away." You entered into an arms-length transaction with your lender in which both of you had competing interests and thus spelled out your obligations in a clear, signed contract. Unless the contract states that you have a "moral obligation to pay," then it's plain and simple--you don't.

The sanctions strategic defaulters face

There are marketplace sanctions that will bring consequences to the defaulting party. Banks will ultimately sue and in many state jurisdictions can obtain deficiency judgments that can be executed on borrowers' assets for years to come. Because the problem is too large to be efficiently dealt with in the near term by many lenders doesn't mean that there won't be difficult consequences for the borrower to deal with in years to come.

One of the principal sanctions is that of ruining one's credit bureau score. A home mortgage default can drop a credit score by 300 points according to some estimates and the history can remain on one's record for up to seven years.

Still, there are some who will elect the inconvenience of a significantly blemished score for the perceived advantages of getting out from under a home deal that in hindsight turned sour.

A time for determination

I hope that we as an industry will pursue all our remedies against these people who were willing enough to accept our terms and conditions when it suited them but renounce them when it did not. I hope, too, that our underwriting practices in the future include in addition to more rigorous credit terms and conditions a similarly rigorous due diligence on the character and integrity of the borrower.

Folk should remember that there are consequences. The result in years to come will likely be a reduced flow of mortgage credit and curtailed opportunities for home ownership.

My wife and I raised four children and certainly want our children and our grandchildren to enjoy their own homes with the physical safety and amenities that home ownership affords.

Unfortunately, there are some who have a twisted and perverted view of basic business transactions. It's our job as lenders to protect the bank from such. As the punch line of the old story goes, "Fool me once, your fault; fool me twice, my fault."

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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