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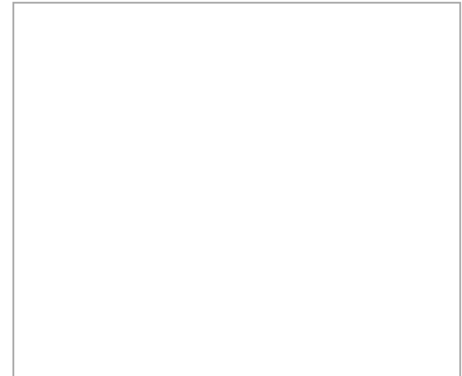
US housing market hit by 'walkaways'

By Aline van Duyn
Published: February 22 2010 22:13 | Last updated: February 22 2010 22:13

Wayne B, a 62-year-old executive who works at an airport, and his wife Orapin, a dental assistant, are about to do something odd. The couple, with a pristine credit history, have decided to default on their $500,000 (£325,000, €370,000) mortgage on a townhouse in Livermore, a respectable city in California's San Francisco Bay area.

It is not that they are unable to afford the $4,600 monthly mortgage outgoings: they have never missed a payment. But the house they bought for $582,000 in May 2006 – at the peak of the US housing boom – is now not likely to be worth more than $315,000.



"The process towards a default has started," says Wayne, whose lender does not yet know it will soon be left nursing losses on yet another foreclosed house – and one whose owner, among the top-rated in terms of creditworthiness, is an implausible-sounding default risk. "We plan to retire in four years and will not be able to afford the mortgage payments then," he explains. "The loss if we sell will be so large that, after doing a lot of research, we have made a business decision to walk away."

The high level of foreclosures in the US – the handing over of homes to banks that lent people money to buy them – has been a huge burden on the economy, has kept house prices on a downward spiral and has resulted in misery and anxiety for millions of people. In some areas so many homes have been abandoned that the entire community has fallen apart as schools close, public services are cut and homes are ransacked for fittings or taken over by criminals. That has also sent property values plunging for those people still in their homes and paying mortgages.

Stemming foreclosures is a key policy objective of President Barack Obama's administration. Various programmes are being worked on to modify people's mortgages in an attempt to reduce payments so that the mortgages are not defaulted on, but so far with only limited success.

The US housing crisis and the foreclosure wave have also been the fuel behind hundreds of billions of dollars in losses for banks and investors around the world – owners either of the defaulted mortgages themselves or of securities linked to their value. Famously, the biggest source of losses came from subprime mortgages – loans given in cavalier fashion to people with poor credit histories. When those borrowers began to default, it triggered the most widespread collapse of housing prices across the US seen since the 1930s.

Prices are still falling. So the extent of losses banks and investors will have to take on mortgages that are still being paid every month, but may not be for longer, hangs large over the US economy. Without a recovery in house prices, consumer spending and confidence in the US is expected to remain muted, reducing the potential for economic growth.

Homes and the range
US mortgage delinquencies

Further losses on mortgages could result in more pain for banks, too, reducing the

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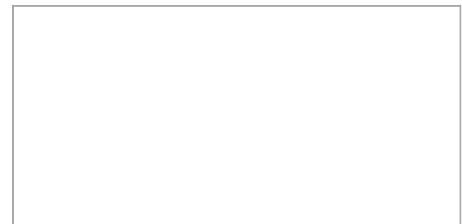

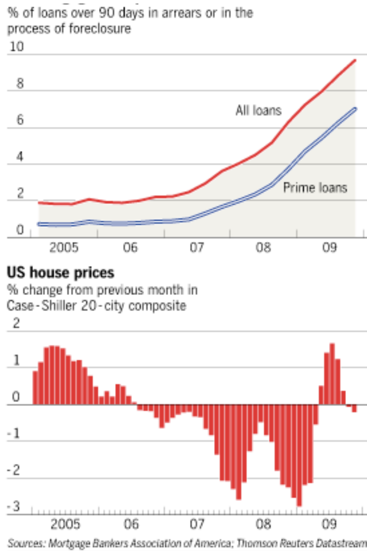

amount of new credit that they can make available to consumers and businesses. This, in turn, would have knock-on effects for the global economic outlook, as the US remains one of the biggest drivers of international trade and commerce.

The behaviour of people like Wayne could therefore be crucial. With a growing number of Americans facing negative equity – where the mortgage exceeds a property's current market value – and becoming ever more pessimistic about the prospects of house prices recovering to make up that difference, they are surrendering to foreclosure even though they can still meet the repayments.

The trend is clear in recent rates of non-payment, or delinquency, on mortgages. In January, delinquencies on outstanding "jumbo" mortgages – big loans granted to people with good credit histories – rose to 9.6 per cent, according to Fitch Ratings. Many of these problem loans, which have gone unserviced for 60 days or more, were taken out after 2005. And non-payment is increasing not just in hard-hit states such as California: in New York, Florida, Virginia and New Jersey they are all on the rise too.

"These are all states where many of the mortgage holders are educated people and it is easy to connect the dots and conclude that these people are deciding it is no longer worth paying a mortgage if they are under water," says Ivy Zelman, a housing market analyst.

She expects US house prices could fall another 10 per cent under the combined weight of the build-up of unsold foreclosed houses, cash-strapped people unable to keep paying mortgages and people facing negative equity deciding simply to hand over their home to their banks.

Aclose look at mortgage payment trouble spots shows that the higher the negative equity, the higher the rate of non-payments. Fitch has found that for all the mortgages provided in the private market, householders with no equity have a delinquency rate of nearly 40 per cent, double that of homeowners who have a stake in their property.

For those with mortgages worth 50 per cent more than their homes, the delinquency figures are over 50 per cent, and these fall as the ratios fall.

Particular concern surrounds defaults by people who merely face negative equity rather than monthly funding problems. These "strategic defaults" may be accelerating as more people shrug aside societal pressure to meet debts if they can.

How to get out of debt

In many US states, if a home loan goes sour, mortgage lenders are entitled to claim only the property on which they provided the funds. Lenders generally have limited or no recourse to the other assets or future income of a borrower if there is a loss on the loan. Borrowers are not liable for any debts except those covered by the value of the home.

This feature of the US mortgage market is a main reason people can "walk away" from properties. In many other countries, including Britain, that is not so easy to do. Borrowers can still be liable for the difference between the size of their mortgage and the value of a home, even if house prices fall and people enter negative equity.

In previous housing downturns, the vast majority made every effort to pay their mortgage, which tended to be the last debt that was defaulted on. Now, as mortgages have become a more impersonal transaction (long-term relationships are rarely built up with mortgage brokers, and many homeowners knew their loans would have been repackaged into bonds and sold to investors around the globe), patterns have changed. As more people move around to find work or better living circumstances, they have less of a "home for life" approach to their houses – and mortgages no longer have so special a status.

Nevertheless, giving up on such a debt is still something that often causes emotional turmoil. Shasta Gaughen, a 39-year-old PhD graduate in anthropology who works with a Native American tribe in California, a few weeks ago stopped paying her mortgage. The one-bedroom condominium she bought for $196,000 in October 2005 is now worth just $60,000 and she has decided to default, "after two years of agonising".

"The biggest problem is trying to convince myself it is not morally wrong to walk away," she says. "I'm approaching my home as an investment that went bad. I'm not stealing anything, the bank will get the property. But my parents raised me to be responsible." She has decided the "responsible" thing for her to do is get out of the flat and rent somewhere else for less than the $1,200 monthly mortgage payments.

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A mortgage default could make renting a little more expensive but landlords already have signs out saying "bad credit accepted".

The problems with negative equity are known, but so far there is no government strategy for tackling it. One concern is that giving some homeowners a reduction on their loans (a loss the banks would have to take on the chin) could evoke resentment among others who did not qualify and might themselves stop payments. Ideas to limit this "moral hazard" include requiring homeowners to give the mortgage lender a stake in the house if a loan is refinanced, meaning that any future price gains would be shared between homeowner and lender.

"Negative equity is a big challenge. It contributes to higher delinquency and redefault rates," Seth Wheeler, senior adviser at the US Treasury, told a conference this month. "We will continue to study the reduction of principal where appropriate," he adds, though the form it would take has not yet been determined.

Many mortgage investors and housing experts believe it has to be dealt with. "The housing problems run very deep, but so far policies have just kicked the can down the road," says Laurie Goodman, analyst at Amherst Securities, a broker that specialises in mortgage investments. "To get an economic recovery you need to fix the housing problem. And to fix the housing problem, you need to fix the negative equity problem."

As well as banks, investors owning the mortgages that were repackaged in the last decade are also concerned that there will be further losses on many of these bonds that have already fallen in value. With foreclosure patterns difficult to predict as even people with excellent credit histories and high incomes choose to default, it becomes harder to determine which securities will keep paying and which will not. Foreclosures eventually feed through to reduced interest payments on the securities.

This matters, not least because the private financing of mortgages in the US is at a virtual standstill. The market is all but entirely financed by the US government through **Fannie Mae** and Freddie Mac, the country's twin federally backed mortgage agencies.

Nancy Mueller Handal, managing director at **Metlife**, a large insurance company, says nearly one-quarter of the group's assets are invested in mortgage-backed securities. However, she says Metlife will not buy new securities until it knows what will happen to the current ones – and whether investors will have to absorb the resulting losses. The lack of clarity on foreclosures and house prices means she is still not sure whether the value of the securities will fall further.

In the meantime, Ms Gaughen is waiting to hear from her bank, Bank of America. She has hired You Walk Away, a company that offers legal advice, tracks the documentation process and lets people know how close they are to eviction.

You Walk Away estimates that she can live in the apartment without paying the mortgage for 12-16 months, leaving her with a nest-egg of cash at the end. Jon Maddux, chief executive, says the time people can stay has been steadily growing. His company, which charges a flat fee of around $1,000 for its services, started just over two years ago. At that time, most of his clients were extremely agitated and phone calls were often peppered with tears, Mr Maddux says.

Now, most customers are much less emotional about the information they are seeking. He estimates that 80 per cent of people signing up for advice are – like Wayne B in Livermore – paying their mortgages but opting to default anyway. "It is now a business decision that more and more people are choosing to make."

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