UNDERWATER AND NOT WALKING AWAY: SHAME, FEAR, AND THE SOCIAL MANAGEMENT OF THE HOUSING CRISIS

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INTRODUCTION

Millions of homeowners in the United States are "underwater" on their mortgages, meaning that they owe more than their homes are worth.[1] Yet, despite all the concern over homeowners who are simply "walking away" from their homes,[2] the vast majority of

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1. *See* CONG. OVERSIGHT PANEL, OCTOBER OVERSIGHT REPORT: AN ASSESSMENT OF FORECLOSURE MITIGATION EFFORTS AFTER SIX MONTHS 24 (2009), *available at* http://cop.senate.gov/documents/cop-100909-report.pdf (reporting that between 15–18 million homeowners are, or soon may be, underwater); *Summary of Second Quarter 2009 Negative Equity Data from First American CoreLogic*, FIRST AM. CORELOGIC (Aug. 13, 2009), http://www.facorelogic.com/uploadedFiles/Newsroom/RES_in_the_News/FACL%20Negative%20Equity_final_081309.pdf [hereinafter *Second Quarter Negative Equity Summary*] (reporting that 15.2 million U.S. mortgages were underwater in the second quarter of 2009).

2. *See, e.g.*, David Streitfeld, *They're Not Paying Anymore*, N.Y. TIMES, July 26, 2009, at WK6 (noting creditor concern about debtor default); *60 Minutes: The U.S. Mortgage Meltdown* (CBS television broadcast May 25, 2008), *available at* http://www.cbsnews.com/video/watch/?id=4126094n&tag=related;photovideo; *Cavuto: The Deal: Walk Away from Your Home* (Fox Business television broadcast Feb. 19, 2009), *available at* http://video.foxbusiness.com/v/3883581/walk-away-from-your-home/; Brian Eckhouse, *Whether To Walk Away: Housing's Moral Minefield*, LAS VEGAS SUN (Mar. 22, 2009), http://www.lasvegassun.com/news/2009/mar/22/whether-walk-away-housings-moral-minefield/; Barbara Kiviat, *Walking Away From Your Mortgage*, TIME.COM (June 19, 2008), http://www.time.com/time/magazine/article/0,9171,1816472,00.html; Liz Pulliam Weston, *When To Walk Away from a Mortgage*, MSN, http://articles.moneycentral.msn.com/Banking/HomeFinancing/WhenToWalkAwayFromAMortgage.aspx (last visited Oct. 9, 2010); John A. Schoen, *Why It's a Bad Idea To Walk from the Mortgage*, MSNBC.COM (Mar. 16, 2009), http://www.msnbc.msn.com/id/29669640/; Eric Weiner, *Why Not Just Walk Away from A Home?*, NPR (Feb. 13, 2008),

underwater homeowners continue to make their mortgage payments—even when they are hundreds of thousands of dollars underwater and have no reasonable prospect of recouping their losses.[3] This includes underwater homeowners who live in "nonrecourse states" such as California and Arizona,[4] where lenders cannot pursue defaulting homeowners for a deficiency judgment.[5]

While such behavior may appear irrational on its face,[6] behavioral economists explain that underwater homeowners simply suffer from the same kind of cognitive biases that lead individuals to make other suboptimal economic decisions.[7] Underwater homeowners aren't knowingly making bad choices; they just don't cognitively grasp that they would be better off if they walked away from their mortgages.[8]

The behavioral economist's explanation does not account, however, for homeowners who are fully aware that it would be in their financial best interest to default, but still do not do so. This Article suggests that most underwater homeowners choose not to default as a result of two emotional forces: (1) desire to avoid the shame or guilt associated with foreclosure; and (2) fear over the perceived consequences of foreclosure—consequences that are in actuality much less severe than most homeowners have been led to believe.

Moreover, fear, shame, and guilt are not mere "transaction costs" that homeowners calculate according to their own personal tolerance for each. Rather, these emotional constraints are actively cultivated by the government, the financial industry, and other social control agents in order to induce individual homeowners to act in ways that are *against* their own self-interest, but that are—wrongly, this Article contends—argued to be socially beneficial. Unlike lenders who seek to maximize profits irrespective of concerns about morality or social responsibility, individual homeowners are encouraged to behave in accordance with social and moral norms that require individuals keep promises and honor financial obligations. Thus, individual homeowners tend to ignore market and legal norms under which strategic default might not only be a viable option, but also the wisest financial decision. Lenders, on the

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http://www.npr.org/templates/story/story.php?storyId=18958049.

3. *See infra* notes 18–22 and accompanying text.

4. *See infra* notes 11–22 and accompanying text.

5. *See infra* note 52 and accompanying text.

6. *See* Yongheng Deng & John M. Quigley, *Woodhead Behavior and the Pricing of Residential Mortgages* (Univ. of Cal., Berkeley Program on Hous. & Urban Policy Working Paper Series, Paper No. W00-004, 2004), *available at* http://urbanpolicy.berkeley.edu/pdf/DQ_Woodhead_Web.pdf.

7. *See* Peter Ubel, *Human Nature and the Financial Crisis*, FORBES.COM (Feb. 22, 2009), http://www.forbes.com/2009/02/20/behavioral-economics-mortgage-opinions-contributors_financial_crisis.html.

8. *See infra* Part III.

other hand, have generally resisted calls to modify underwater mortgages despite the fact that it would be both socially beneficial and morally responsible for them to do so. This norm asymmetry has led to distributional inequalities in which individual homeowners shoulder a disproportionate financial burden from the housing collapse.

This Article proceeds as follows: Part I shows that, despite widespread concern that underwater homeowners are simply walking away, the vast majority of underwater homeowners have not strategically defaulted on their mortgages. Part II explores the financial logic of walking away from an underwater mortgage and suggests that many more homeowners should be strategically defaulting. Part III argues that, though cognitive biases may account for many underwater homeowners' decisions not to strategically default, emotions such as shame, guilt, and fear play the largest role in homeowner decisions to knowingly eschew "in-the-money" default options. Part IV argues that social control agents such as the government, the media, and the financial industry use both moral suasion and disinformation to cultivate these emotional constraints in homeowners. It also argues that credit-rating agencies play a central role as enforcers of moral and social norms against walking away from one's mortgage. Part V argues that the disparity between the norms governing the behavior of individuals and that of banks has created an imbalance in which individual homeowners have borne a disproportionate financial burden from the housing collapse. Part VI explores ways either to address the distributional inequalities of norm asymmetry or to empower homeowners to renegotiate underwater mortgages on a more level playing field with lenders.

I. UNDERWATER AND STAYING PUT

The collapse of the U.S. housing market has left millions of homeowners owing more on their mortgages than their homes are worth.[9] As a historical snapshot, more than 34% of all mortgaged properties in the United States were "underwater" as of the third quarter of 2009.[10] The national numbers hide the full extent of the

9. *See supra* note 1 and accompanying text.

10. Media Alert, First Am. CoreLogic, First American CoreLogic Releases Q3 Negative Equity Data (Nov. 24, 2009) [hereinafter Media Alert, 2009 Q3 Negative Equity Report], *available at* http://www.loanperformance.com /infocenter/library/FACL_Negative_Equity_Media_Alert_Q3_112409_Final.pdf. Beginning with third-quarter figures from 2009, CoreLogic revised its methodology for the Negative Equity Report to "account for amortization or [home equity lines of credit] utilization." *Id.* Under this changed methodology, CoreLogic reported an estimated 10.7 million residential mortgages with negative equity—approximately 23% of all residential properties with mortgages. *Id.* Using the former methodology—which takes into account a broader landscape of homeowner debt—15.4 million residential mortgages were

problem, however, as the percentage of underwater mortgages has been much higher in the regions suffering the worst price declines. Again, as a snapshot, by the end of 2009, 65% of mortgage borrowers in Nevada were already underwater,[11] 48% of homeowners were underwater in Arizona, 45% were underwater in Florida, 37% were underwater in Michigan, and 35% were underwater in California.[12] The percentage of underwater mortgages was higher still in the hardest-hit metropolitan areas as the table below shows:[13]

underwater, or nearly 34% of homes. *Id.*

This percentage is expected to increase to 48% by the first quarter of 2011. DEUTSCHE BANK, DROWNING IN DEBT—A LOOK AT "UNDERWATER" HOMEOWNERS 5 (2009), *available at* http://www.virtualbroker.com/pdf/2009/mtgreportdeutschebank82009.pdf. In addition, "41% of prime conforming borrowers and 46% of prime jumbo borrowers will be underwater," by which time national housing prices are predicted to have dropped 42% from their peak. *Id.* at 4, 14.

11. Media Alert, 2009 Q3 Negative Equity Report, *supra* note 10. Outstanding Nevadan mortgage debt values were almost sixteen billion dollars, or 14% greater than the underlying property values these loans secured. *Id.* While Nevada was the only state, as of 2009, with a loan-to-value ratio over 100% (signifying negative net homeowner equity), residents of Arizona (91%), Florida (87%), and Michigan (84%) had negative net equity with loan-to-value ratios close to 100%. *Id.*

12. *Id.*

13. DEUTSCHE BANK, *supra* note 10, at 10. This chart uses data from the end of 2009's first quarter as a historical snapshot of the mortgage crisis. *Id.* at 13. While the percentage of underwater homeowners may fluctuate from quarter to quarter, the crucial point is that millions of homeowners across the country are underwater, including the vast majority of homeowners in many communities.

METROPOLITAN STATISTICAL AREA	CURRENT PERCENT UNDERWATER
Merced, CA	85%
El Centro, CA	85%
Modesto, CA	84%
Las Vegas-Paradise, NV	81%
Stockton, CA	81%
Bakersfield, CA	79%
Port St. Lucie, FL	79%
Riverside-San Bernardino-Ontario, CA	78%
Cape Coral-Fort Myers, FL	76%
Yuba City, CA	73%
Madera, CA	72%
Fresno, CA	72%
Orlando-Kissimmee, FL	71%
Visalia-Porterville, CA	70%
Miami-Miami Beach-Kendall, FL	70%
Palm Bay-Melbourne-Titusville, FL	69%
Lakeland-Winter Haven, FL	69%
Phoenix-Mesa-Scottsdale, AZ	68%

Not only are significant numbers of homeowners underwater, but many are underwater by substantial amounts. By the second quarter of 2009, for example, over 16% of homeowners had negative equity exceeding 20% of their home's value, and over 22% of homeowners had negative equity exceeding 10% of their home's value.[14] Again, however, the situation was worse in the hardest-hit markets. For example, 47% of homeowners in Nevada had negative equity exceeding 25% of their home's value, as did 30% of homeowners in Florida, 29% in Arizona, and 25% in California.[15] Moreover, given the high median home prices at the peak within these markets, a large percentage of these homeowners were underwater by hundreds of thousands of dollars.[16]

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14. *See Second Quarter Negative Equity Summary*, *supra* note 1.

15. *Id.*

16. *Id.* For example, a homeowner who bought a home in 2006 in Salinas, California—where home prices have dropped 70% from the peak—has on average $214,000 in negative equity. Luigi Guiso, Paola Sapienza & Luigi Zingales, *Moral and Social Constraints to Strategic Default on Mortgages* 2 (European Univ. Inst., Working Paper No. ECO 2009/27, 2009), *available at* http://www.nber.org/papers/w15145.pdf?new_window=1. Moreover, given that the average home price reached over $605,000 in Salinas at the peak of the market, homeowners who bought even slightly better-than-average homes could easily have negative equity exceeding $300,000. *See Salinas Home Prices and Home Values*, ZILLOW.COM, http://www.zillow.com/local-info/CA-Salinas-home-value/r_54288/ (last visited Oct. 9, 2010) The story is similar, of course, in other California metro areas, including Los Angeles, Modesto, El Centro, Merced, Riverside, and Redding. *See, e.g.*, *Los Angeles Home Prices and Home*

This negative equity was a significant contributing factor to a combined foreclosure and thirty-plus-day delinquency rate that exceeded 14% for home mortgages in the third quarter of 2009, a historic high.[17] However, the high foreclosure and delinquency rate has not been caused by large percentages of homeowners voluntarily walking away from their homes, even though these homeowners can afford the payments. To the contrary, less than one-fourth of homeowner defaults have been strategic,[18] with the other three-fourths triggered by job loss, divorce, or other financial difficulty, which when combined with negative equity give homeowners no option but to let go of their homes.[19] In other words, for the vast

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Values, ZILLOW.COM, http://www.zillow.com/local-info/CA-Los-Angeles-home-value/r_12447/ (last visited Oct. 9, 2010). The situation is also dire outside of California. A homeowner who bought an average home near the price peak in Las Vegas for example—where prices have dropped 58% as of October 2010—would likely have negative equity in excess of $140,000. *See Las Vegas Home Prices and Home Values*, ZILLOW.COM, http://www.zillow.com/local-info/NV-Las-Vegas-home-value/r_18959/ (last visited Oct. 9, 2010). The situation is the same in Miami, where prices are down 52%, *see Miami Home Prices and Home Values*, ZILLOW.COM, http://www.zillow.com/local-info/FL-Miami-home-value/r_12700/ (last visited Oct. 9, 2010), and in Phoenix, where prices have dropped 56%. *See Phoenix Home Prices and Home Values*, ZILLOW.COM, http://www.zillow.com/local-info/AZ-Phoenix-home-value/r_40326/ (last visited Oct. 9, 2010). Furthermore, with such significant price decreases in each of these markets, it stands to reason a large number of individuals who bought more-expensive-than-average homes could easily have negative equity exceeding somewhere around $200,000 to $300,000.

17. As of the third quarter of 2009, the foreclosure rate was 4.47% and the delinquency rate (meaning here loans that were thirty-plus days delinquent) was 9.64%, for a combined rate of 14.36%. MORTG. BANKERS ASS'N, NATIONAL DELINQUENCY SURVEY: THIRD QUARTER 2009, at 2–3 (2009), *available at* http://media.oregonlive.com/frontporch/other/NDS_Q309.pdf. "The delinquency rate includes loans that are at least one payment past due but does not include loans somewhere in the process of foreclosure." Press Release, Mortg. Bankers Ass'n, Delinquencies Continue To Climb in Latest MBA National Delinquency Survey (Nov. 19, 2009), *available at* http://www.mbaa.org/NewsandMedia/PressCenter/71112.htm. Some commentators have referred to the role that negative equity plays in causing foreclosures as "overwhelming" and "incontrovertible." *See, e.g.*, Christopher L. Foote et al., *Reducing Foreclosures* 5 (Fed. Reserve Bank of Boston Pub. Policy Discussion Papers, Paper No. 09–2, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0902.pdf.

18. *See* EXPERIAN & OLIVER WYMAN, EXPERIAN-OLIVER WYMAN MARKET INTELLIGENCE REPORT: UNDERSTANDING STRATEGIC DEFAULT IN MORTGAGES PART I, at 8 (2009) (finding a strategic default rate of 17% based on a review of credit histories of homeowners in default); Guiso, Sapienza & Zingales, *supra* note 16, at 1 (estimating based on surveys of homeowners that nearly a quarter of defaults are strategic).

19. *See* News Release, Fed. Hous. Fin. Agency, FHFA Reports Fannie Mae and Freddie Mac Foreclosure Prevention Efforts for May (Aug. 3, 2009), *available at* http://www.fhfa.gov/webfiles/14723/MayForeclosure_Prevention8309.pdf (noting that the top five reasons for delinquency are income loss (34%), excessive obligations (20%), unemployment (8%), illness of principal mortgagor (6%), and marital difficulties (4%)).

majority of homeowners, negative equity is a necessary but not sufficient condition for default.[20] Indeed, though nearly 34% of U.S. homeowners were underwater on their mortgages by the end of the third quarter of 2009,[21] the overall strategic default rate among all homeowners was only 2.5% to 3.5%.[22]

As further evidence that relatively few homeowners strategically default solely because they have negative equity, housing markets with a sharply higher percentage of underwater homeowners as compared to the national average have not experienced sharply higher default rates. For example, although almost 51% of Arizona homeowners were underwater (compared to 32% nationally) in the second quarter of 2009,[23] the combined foreclosure and thirty-plus-day deficiency rate in Arizona was 16.3%—only slightly above the national average of approximately 13%.[24] As the chart below illustrates, this pattern of relatively low default rates compared to the percentage of underwater mortgages has held true almost universally across the hardest-hit markets, with the default rate much more closely resembling the

20. Moreover, the vast majority of defaults have involved subprime or Alternative A-Paper ("Alt-A") loans—with over 47% of subprime loans nonperforming as of the second quarter of 2009. LAURIE GOODMAN ET AL., AMHERST MORTGAGE INSIGHT, HOUSING OVERHANG/SHADOW INVENTORY = ENORMOUS PROBLEM 9 (2009), http://matrix.millersamuel.com/wp-content/3q09/Amherst%20Mortgage%20Insight%2009232009.pdf; *see also* MORTG. BANKERS ASS'N, NATIONAL DELINQUENCY SURVEY: SECOND QUARTER 2009, at 1–2 (2009), *available at* http://media.spokesman.com/documents/2009/08/Q209_NDS.pdf (finding a delinquency rate of 25.35% and a foreclosure rate of 15.05% for subprime loans). In contrast, the default rate for prime loans was much lower. *See* MORTG. BANKERS ASS'N, *supra*, at 1–2 (finding a delinquency rate of 6.41% and a foreclosure rate of 3% for prime loans). However, as the subprime crisis has mostly run its course, prime fixed-rate loans now account for one in three foreclosure starts. *See* Kevin G. Hall, *Fixed-Rate Mortgage Foreclosures Rising: First-Quarter Numbers Offer Troubling Forecast*, SPOKESMAN-REV. (May 20, 2010), http://www.spokesman.com/stories/2010/may/20/fixed-rate-mortgage-foreclosures-rising/ (reporting the Mortgage Bankers Association's finding that prime-fixed mortgages accounted for nearly 37% of new foreclosures started in the first three months of 2010).

21. Media Alert, 2009 Q3 Negative Equity Report, *supra* note 10.

22. This range is calculated by multiplying the default rate of 14% by 17% and 25%, which are estimates of the percentage of defaults that are strategic. *See supra* note 18 and accompanying text. For a historical comparison, see DEUTSCHE BANK, *supra* note 10, at 14 (noting that 7% of homeowners with negative equity defaulted during the housing bust in Boston in the 1980s and 1990s).

23. *See Second Quarter Negative Equity Summary*, *supra* note 1.

24. MORTG. BANKERS ASS'N, *supra* note 20, at 4.

unemployment rate than the underwater percentage:

METROPOLITAN STATISTICAL AREA	PERCENT UNDERWATER[a]	SERIOUS DELINQUENCY RATE[b]	UNEMPLOYMENT RATE[c]
Merced, CA	85%	18.99%	17.5%
Modesto, CA	84%	15.10%	16.1%
Las Vegas-Paradise, NV	81%	15.53%	11.3%
Stockton, CA	81%	16.20%	15.5%
Bakersfield, CA	79%	11.92%	13.9%
Port St. Lucie, FL	79%	17.30%	14.1%
Riverside-San Bernardino-Ontario, CA	78%	15.19%	13.7%
Orlando-Kissimmee, FL	71%	16.63%	10.7%
Palm Bay-Melbourne-Titusville, FL	69%	10.92%	11.1%
Lakeland-Winter Haven, FL	69%	14.05%	11.9%
Phoenix-Mesa-Scottsdale, AZ	68%	10.09%	7.7%
Tampa-St. Petersburg-Clearwater, FL	65%	11.71%	11.2%
West Palm Beach-Boca Raton-Boynton Beach, FL	64%	15.28%	11.2%
Salinas, CA	51%	12.62%	11.7%

[a] The underwater percentages are derived from DEUTSCHE BANK, DROWNING IN DEBT—A LOOK AT "UNDERWATER" HOMEOWNERS 10 (2009), *available at* http://www.virtualbroker.com/pdf/2009/mtgreportdeutschebank82009.pdf.

[b] The serious delinquency rate for each locality is the combined percentage of mortgages that more than ninety days delinquent or in foreclosure. Paul S. Calem et al., *Spatial Patterns of Mortgage Delinquency in Major U.S. Metropolitan Areas*, MARKETPULSE, June 2009, at 12, *available at* http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/mp%2009%20june%20full%20issue%20cl.pdf.

[c] The unemployment rates are listed in DEUTSCHE BANK, UPDATE: THE OUTLOOK FOR U.S. HOME PRICES 24–26 (2009), *available at* http://www.docstoc.com/docs/document-preview.aspx?doc_id=7719243.

These numbers strongly suggest that factors other than strategic defaults have been driving the delinquency rate, with unemployment the most likely culprit.[25] Indeed, given the striking disparity between the percentage of underwater homeowners and the percentage of defaults, the real mystery is not—as media coverage has suggested—why large numbers of homeowners have been walking away, but why, given the percentage of underwater mortgages, more homeowners have not been.[26]

II. THE FINANCIAL LOGIC OF WALKING AWAY

Before examining why more underwater homeowners have not been strategically defaulting, it might be helpful to explore why they should. A textbook premise of economics is that the value of a home—even an owner-occupied one—is "the current value of the rent payments that could be earned from renting the property at market prices."[27] In other words, when the net cost of buying a home exceeds the net cost of renting, one is better off renting. The

25. *See* CONG. OVERSIGHT PANEL, *supra* note 1, at 19–21 (discussing "fifth wave" of foreclosures caused by unemployment); DEUTSCHE BANK, UPDATE: THE OUTLOOK FOR U.S. HOME PRICES: BEYOND THE BUBBLE 9 (2009) (discussing the role of unemployment as the primary risk factor for default); Alan Zibel, *Foreclosures Rise 5 Percent from Summer to Fall*, ABC NEWS, Oct. 15, 2009, http://abcnews.go.com/US/wireStory?id=8832354 ("Unemployment is the main reason homeowners are falling into trouble. While the economy is likely out of recession, the unemployment rate—now at a 26-year high of 9.8%—isn't expected to peak until the middle of next year.").
Information for the Miami-Fort Lauderdale area is excluded from this chart due to the high concentration of non-owner-occupied investment properties in the Miami-Fort Lauderdale area, which has resulted in a deficiency rate more than double the unemployment rate. *See* Kate Berry, *Wary of Default, Banks Curtail Loans to Investors*, AM. BANKER (Oct. 9, 2009), http://www.americanbanker.com/news/wary_of_default_banks_curtail_loans_to_investors-1002848-1.html (noting that, many real estate investors "in second-home markets" such as Miami, Las Vegas, and Phoenix, "simply turned in their keys [to banks], defaulting on scores of second homes and investment properties that they had intended to flip"); *see also* DEUTSCHE BANK, *supra* note 10, at 10 (listing underwater percentage for the Miami metropolitan statistical area ("MSA") of 70%, and 69% for the Fort Lauderdale MSA); DEUTSCHE BANK, UPDATE: THE OUTLOOK FOR U.S. HOME PRICES 24–25 (2009), *available at* http://www.docstoc.com/docs/document-preview.aspx?doc_id=7719243 (listing unemployment rate in Miami of 8.5%, and 9.3% in the Fort Lauderdale MSA); Paul S. Calem et al., *Spatial Patterns of Mortgage Delinquency in Major U.S. Metropolitan Areas*, MARKETPULSE, June 2009, at 12, *available at* http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/mp%2009%20june%20full%20issue%20cl.pdf (listing serious delinquency rate for the Miami MSA of 22.14%, and 18.12% for the Fort Lauderdale MSA).

26. For examples of the media hype regarding the purported walk-away phenomenon, see *supra* note 2.

27. HYE JIN RHO ET AL., THE CHANGING PROSPECTS FOR BUILDING HOME EQUITY: AN UPDATED ANALYSIS OF RENTS AND THE PRICE OF HOUSING IN 100 METROPOLITAN AREAS 3 (2008), *available at* http://www.cepr.net/documents/publications/Changing_Prospects_for_Building_Home_Equity_2008_10.pdf.

equation is not as simple, however, as comparing total mortgage payments to rent payments because home ownership carries certain benefits, including tax breaks and the potential for appreciation.[28] Additionally, assuming a nondepreciating market, the portion of the mortgage payment that goes to principal rather than to interest will eventually inure to the homeowner at the time of sale.[29] On the flip side, homeownership carries significant costs that renting does not, including maintenance, homeowner's insurance, and substantial transaction costs upon selling.[30]

In calculating whether to buy or to rent, a potential homebuyer should compare the net cost of owning a home to the net cost of renting a similar home over the expected period of occupancy. The cost of owning includes the interest-only portion of the loan payment, property taxes, maintenance costs, homeowner's insurance, and transaction costs upon selling, minus the expected appreciation and cumulative tax savings over the planned period of ownership. As a rule of thumb, a potential homebuyer is generally better off renting when the home price exceeds fifteen or sixteen times the annual rent for comparable homes.[31]

The calculation for a rational homeowner in deciding whether to strategically default on a home mortgage is similar to that for buying; the base calculation is still the cost of renting versus the cost of continuing to own.[32] However, the underwater homeowner has additional considerations, including existing negative equity on the one hand and the costs of foreclosure on the other.[33] Even

28. *See* Bradford P. Anderson, *Welcome to My Flipperhood: A Call To Repair the Residential Real Estate Tax Swindle*, 7 GEO. J.L. & PUB. POL'Y 415, 420–22 (2009) (discussing tax benefits for residential real properties); Jeffrey T. Lawyer, Note, *Vacation Homes, Section 280A and* Bolton v. Commissioner*: The Right Result for the Wrong Reasons*, 1985 DUKE L.J. 793, 810 n.102 (noting that homes have the potential for appreciation).

29. This is because in the traditional mortgage design each installment paid by the borrower compensates the lender both for the full impact of inflation on the outstanding loan balance and for the real interest and some of the real principal. *See* Michael S. Knoll, *Taxation, Negative Amortization and Affordable Mortgages*, 53 OHIO ST. L.J. 1341, 1346 (1992).

30. *See* Luke Mullins, *12 Hidden Costs of Homeownership*, U.S. NEWS & WORLD REP. (Apr. 8, 2010), http://money.usnews.com/money/personal-finance/real-estate/articles/2010/04/08/12-hidden-costs-of-homeownership.html.

31. RHO ET AL., *supra* note 27, at 4. Historical home prices have hewed to a price-to-annual-rent ratio of roughly fifteen to one—except during bubbles. *Id.* at 4 & n.3.

32. As a caveat, for homeowners with sufficient resources to purchase another home before bailing on the first, the calculation might actually be the cost of buying a new home (rather than renting) versus continuing to own their current home. *See* Nick Timiraos, *Some Buy a New Home To Bail on the Old*, WALL ST. J., June 11, 2008, at A3.

33. *See* JOSH ROSNER, GRAHAMFISHER, HOUSING IN THE NEW MILLENNIUM: A HOME WITHOUT EQUITY IS JUST A RENTAL WITH DEBT 13 (2001), *available at* http://ssrn.com/abstract=1162456 (discussing how lack of equity changes the default calculation).

leaving aside foreclosure costs, the calculation as to whether one is financially better off defaulting requires one to consider several additional variables for which one may not have wholly reliable information. These variables include a reasonable estimate of the current value of one's home, the cost to rent a similar home, an idea of how long one intends to stay in the home, and an estimate of the average appreciation or depreciation one's home is likely to experience over that period of time. While each variable requires some guessing, there is a wealth of information available to assist homeowners in making rational estimates, should they endeavor to do so.[34]

With these estimates in hand, homeowners also need to know the current principal balance on their mortgage(s); the cost of the monthly interest-only portion of their mortgage(s); the cost of monthly mortgage insurance, if any; the amount of monthly taxes, insurance, and homeowners' association dues, if any; and their annual tax savings from owning versus renting. A rational homeowner can then make relatively simple calculations as to how much money he would save or lose by walking away, both on a monthly basis and over time. He can also predict how long it will take to recover their equity.[35]

Consider, for example, Sam and Chris, a young professional couple with two small children, who stretched to buy their first home—an average three-bedroom, 1380-square-foot house in

34. For example, both the Home Price Calculator and Zillow.com can provide most homeowners with a reasonably accurate estimate of their home's value. *See HPI Calculator*, FED. HOUSING FIN. AGENCY, http://www.fhfa.gov/Default.aspx?Page=86 (last visited Oct. 9, 2010); ZILLOW.COM, http://www.zillow.com (last visited Oct. 9, 2010). Or, if a home is particularly unique, one can have the home appraised by a professional appraiser. Similarly, one could have a real estate management company give an estimate as to how much one's home would rent for, or simply look in the newspaper and online to see what similar homes are renting for. Moreover, there are considerable amounts of market-specific research available on the Internet that can help rational individuals predict the amount of appreciation or depreciation their home is likely to experience over a given period of time. *See, e.g.*, Peter C. Beller, *Why Housing Hasn't Bottomed,* FORBES.COM (Oct. 15, 2009), http://www.forbes.com/2009/10/15/real-estate-ownership-markets-equities-renting.html; Francesca Levy, *Where Home Prices Are Hitting Bottom*, FORBES.COM (Sept. 18, 2009), http://www.forbes.com/2009/09/18/home-prices-bottoming-lifestyle-real-estate-home-prices.html. Or a rational individual in a nondepreciating market might simply count on appreciation at around the historical home appreciation rate of 3–4% per year. *See* ClariTree Team, *U.S. Home Appreciation Rates*, CLARITREE (Oct. 27, 2009), http://claritree.com/us-home-appreciation-rates (finding a historical appreciation rate between 3% and 4%).

35. For the mathematically challenged, there are online calculators, such as the one at YouWalkAway.com, that do these calculations automatically. *See, e.g.*, *Does It Make Financial Sense to Walk Away & Rent?*, YOUWALKAWAY.COM, http://www.youwalkaway.com/output24/InterectiveFlashCalculator.html (last visited Oct. 9, 2010).

Salinas, California—for $609,000 in January of 2006.[36] Sam and Chris had excellent credit and a solid income, and were thus able to qualify for a thirty-year fixed-interest loan with nothing down. At an interest rate of 6.5%, their total monthly payment is approximately $4450,[37] which is just under 31% of their gross monthly income, and within the payment-to-income ratio considered "affordable" by most lenders.[38] However, after paying for taxes, health insurance, student loans, childcare, automobiles, food, and other necessities, Sam and Chris do well to break even each month. At the time they bought their home, they were not overly concerned about this, as they saw their mortgage payment itself as an investment in their own and their children's futures.

Unfortunately for Sam and Chris, the housing market began to collapse in 2007.[39] Though they still owe about $578,000 on their home,[40] it is now only worth about $236,000.[41] Sam and Chris could rent a similar house in the neighborhood for about $1800, compared to the $4450 they currently pay.[42]

Assuming they intend to stay in their home for ten years, Sam and Chris could save approximately $310,000 by walking away, including a monthly savings of at least $2120 by renting rather than making mortgage payments, even after factoring in the mortgage interest tax deduction. The financial gain for Sam and Chris from walking away could be even more substantial if they took their monthly savings and put it into an investment account. If they stay in their home, on the other hand, it will take Sam and Chris over forty years just to recover their equity—assuming, of course, that

36. This example is a hypothetical based on the peak cost of an average-priced and average-sized home in Salinas in January 2006. *See Salinas Home Prices and Home Values*, *supra* note 16 (listing $609,000 as the average Salinas home price in January 2006).

37. This calculation assumes a loan of $609,000 at an annual interest rate of 6.5%, monthly mortgage insurance of $233, monthly taxes of $250, and monthly homeowner's insurance of $120.

38. *See, e.g.*, *How Much House Can You Afford?*, CNNMONEY.COM, http://cgi.money.cnn.com/tools/houseafford/houseafford.html (last visited Oct. 9, 2010); *Home Affordable Modification*, BANK OF AM., http://homeloanhelp.bankofamerica.com/en/home-affordable-modification.html (last visited Oct. 9, 2010).

39. *See* Steven Gjerstad & Vernon L. Smith, Opinion, *From Bubble to Depression?*, WALL ST. J., Apr. 6, 2009, at A15.

40. This calculation is based on amortization at fifty-four months, with approximately $730 going toward principal each month. The remaining $3720 of the payment is interest, taxes, and insurance.

41. This price is based on Zillow data for average home values in Salinas, California on July 1, 2010. *See Salinas Home Prices and Home Values*, *supra* note 16 (indicating that the average home price reached $609,000 in January 2006 and that the average home was worth only $236,000 in July 2010).

42. This is based on prices of homes currently listed for sale on Zillow.com in Salinas, California, *id.*, and average rent identified in RHO ET AL., *supra* note 27, at 11.

they live that long, that the market in Salinas has indeed hit bottom, and, optimistically, that their home appreciates at the historical appreciation rate of approximately 3.5%.[43]

Millions of homeowners who bought homes in the last five years are in situations similar to that of Sam and Chris, particularly in the hardest-hit states of California, Florida, Nevada, and Arizona. For example, a homeowner who bought an average home in Miami at the peak of the housing market would have paid around $360,000.[44] That home would now be worth only about $159,000, and, assuming a 5% down payment, the homeowner would have approximately $170,000 in negative equity.[45] Assuming he intended to live in the house for five years, he could save approximately $147,000 by walking away and renting a comparable home.[46] Or, he could stay and take twenty-five years just to recover lost equity—all the while throwing away $1420 a month in net savings that he could invest elsewhere. The advantage of walking away is even more starkly evident for the large percentage of individuals who bought more-expensive-than-average homes in the Miami area—or in any bubble market for that matter[47]—in the last five years. Millions of U.S. homeowners could save hundreds of thousands of dollars by strategically defaulting on their mortgages.[48]

Homeowners should be walking away in droves. But they aren't. And it's not because the financial costs of foreclosure outweigh the benefits. To be sure, foreclosure comes with costs, including a significant negative impact on one's credit rating.[49] But

43. *See* ClariTree Team, *supra* note 34 (indicating that historical appreciation rates for home prices have been between 3% and 4%).

44. *See Miami Home Prices and Home Values*, *supra* note 16.

45. *Id.* (assuming 5% down with an interest rate at the national average of 6.5% for June 2007).

46. This assumes monthly interest of $1824, mortgage insurance of $219, taxes of $250, and homeowner's insurance of $100, with a balance of $329,830 remaining on the mortgage. This also assumes that a comparable home could be rented for $1000. For the mortgage insurance estimate, see *PMI Calculator*, GOODMORTGAGE.COM, http://www.goodmortgage.com/Calculators/PMI.html (last visited Oct. 9, 2010).

47. See RHO ET AL., *supra* note 27, at 14–17 (listing "bubble markets").

48. Average national numbers show that home prices have declined 25% nationally from $240,000, at the peak, to $189,000 in June of 2009. *See Real Estate Market Reports*, ZILLOW.COM, http://www.zillow.com/local-info/#metric=mt%3D34%26dt%3D1%26tp%3D5%26rt%3D14%26r%3D102001 (last visited Oct. 9, 2010).

49. Just how much impact a foreclosure has on one's credit is unclear because the Fair Isaac Corporation will not share this information. But generally, one can expect a 100 to 140 point hit to his or her credit as a result of a foreclosure, and additional hits for each late payment, which are generally reported separately from the foreclosure itself. *See* Dave Dinkel, *How Does Foreclosure Impact Your Credit Report*, ARTICLESBASE.COM (Oct. 13, 2007), http://www.articlesbase.com/real-estate-articles/how-does-foreclosure-impact-your-credit-report-234979.html. The total hit from late payments and a foreclosure could be as much as 300 to 400 points. *See* Nina Silberstein, *How*

assuming one had otherwise good credit and continues to meet other credit obligations, one can have a good credit rating again—meaning above 660—within two years after a foreclosure.[50] Additionally, one can qualify for a federally insured Federal Housing Administration ("FHA") loan to purchase another home in as little as three years if the foreclosure was caused by unemployment or other extenuating circumstances, and in five years absent such a precipitating event.[51]

While the actual financial cost of having a poor credit score for a few years may be hard to quantify, it is not likely to be significant

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Foreclosure Affects Your Credit Score and Your Life, AOL REAL EST., http://realestate.aol.com/article/credit/_a/how-foreclosure-affects-your-credit-score/2009041001 (last visited Oct. 9, 2010) (recognizing credit-score drops of up to 300 points following foreclosure); Elizabeth Weintraub, *Should You Choose a Shortsale over a Foreclosure?*, ABOUT.COM, http://homebuying.about.com/od/foreclosures/f/072509_Short-Sale-vs-Foreclosure.htm (last visited Oct. 9, 2010) (reporting anecdotal evidence of 200 to 400 point credit score drops following foreclosure). Additionally, one must wait seven years before the foreclosure disappears from one's credit report entirely. Dinkel, *supra*.

50. *See* Mike Clover, *Mortgage Fixes and Your Credit Scores*, CREDITSCOREQUICK.COM (Aug. 5, 2009, 8:55 PM), http://www.creditscorequick.com/blog/2009/08/05/mortgage-fixes-and-your-credit-scores/ (noting that credit scores can improve within two years after foreclosure if other credit accounts are kept current); Mike Clover, *Revive Credit Report After Foreclosure*, CREDITSCOREQUICK.COM (Mar. 17, 2008, 12:20 AM), http://www.creditscorequick.com/blog/2008/03/17/revive-credit-report-after-foreclosure/ ("Your credit report might recover quickly as long as you have other good standing credit reporting on your credit report."); Marilyn Kennedy Melia, *Life After Foreclosure*, BANKRATE.COM (Sept. 4, 2009), http://www.bankrate.com/finance/mortgages/life-after-foreclosure-1.aspx ("If a foreclosure is an isolated event on an otherwise good credit record, consumers may be able to rehabilitate their record and garner better loans and card rates in 24 months.").

51. *See* Kenneth R. Harney, *The Nation's Housing: Walking Away from a Mortgage*, WASH. POST, Nov. 28, 2009, at E01 (suggesting, contrary to the FHA website, that a homeowner who walks away can only obtain a new FHA loan within three years if he or she demonstrates extenuating circumstances; otherwise the homeowner must wait five years); *100 Questions & Answers About Buying a New Home*, U.S. DEPARTMENT HOUSING & URB. DEV., http://www.hud.gov/offices/hsg/sfh/buying/buyhm.cfm#How (last visited Oct. 9, 2010) (outlining FHA loan qualification in questions 71–81). Because banks are often much more willing to negotiate a short sale once it becomes clear that a homeowner intends to default, it need not result, and often does not result, in a foreclosure. *See* Sharlene Hensrud, *Foreclosure Piece of Market Pie Continues To Shrink*, HOMESMSP REAL EST. BLOG (Apr. 30, 2010), http://www.homesmsprealestateblog.com/2010/04/foreclosure-piece-of-market-pie-continues-to-shrink.html. The negative effect of a short sale on one's credit is significantly less severe than a foreclosure and depends on the negotiated agreement between the borrower and the lender. For example, if the lender agrees to report the loan as "paid," there is no negative impact, whereas if the lender reports it "settled," the negative impact can be quite significant. *See Short Sales vs. Foreclosures – The Real Deal*, AOL REAL EST. (July 11, 2008), http://realestate.aol.com/article/_a/short-sales-vs-foreclosures-the-real/20080710013009990001.

for most individuals—especially not when compared to the savings achieved by walking away from a seriously underwater mortgage. Whereas a good credit score might save an average person tens of thousands of dollars over the course of a *lifetime*, a few years of poor credit shouldn't cost more than few thousand dollars. Moreover, one who plans to strategically default can take steps to minimize even this marginal cost. For example, one could purchase a new vehicle, secure a new home to rent, or even purchase a new house before beginning the process of defaulting on one's mortgage. Most individuals should be able to plan in advance for a few years of limited credit.

There are, of course, costs to foreclosure other than temporarily poor credit. These include moving costs and possible transportation costs if one is required to live farther from work or school. But again, these costs are minimal when compared to the savings from shedding a home that is hundreds of thousands of dollars underwater. The most significant financial risk from a foreclosure is the risk of a deficiency judgment or, in the alternative, tax liability for the unsatisfied portion of one's loan upon foreclosure. But even these potential costs are significantly less than one might expect. First, a number of states—including many of those with the biggest declines in home values—are nonrecourse states, meaning states where lenders may not pursue homeowners for a deficiency judgment if the home was their primary residence.[52] Second, even in recourse states, lenders rarely pursue borrowers for deficiency judgments unless they have special reason to suspect the borrower has means to pay it.[53] This is particularly true when the home is in a state where lenders are overwhelmed with foreclosures.[54] Third, tax regulations have recently changed to waive taxes on the unpaid portion of a mortgage upon foreclosure, which was previously classified as income to the borrower if the lender reported it as such.[55]

52. *See* Grant S. Nelson, *Confronting the Mortgage Meltdown: A Brief for the Federalization of State Mortgage Foreclosure Law*, 37 PEPP. L. REV. 583, 631–32 (2010) (noting that in twenty-one states, including California, Arizona, and North Carolina, most home mortgage loans are nonrecourse).

53. *See* Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1113 (2009) (finding that even in recourse states, deficiency actions are often not cost-effective for the lender, thus turning recourse loans into de facto nonrecourse loans).

54. *See* Peter S. Goodman, *A Plan To Stem Foreclosures, Buried in a Paper Avalanche*, N.Y. TIMES, June 29, 2009, at A1 (recognizing the lack of lender capacity to address the number of foreclosures).

55. The Mortgage Forgiveness Debt Relief Act of 2007 excludes income from the discharge of debt on principal residences. Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, § 2, 121 Stat. 1803, 1803–04 (2007) (codified as amended in scattered sections of 26 U.S.C.). Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for relief. *See The Mortgage Forgiveness Debt Relief Act*

In short, the financial costs of foreclosure, while not insignificant, are minimal compared to the financial benefit of strategic default, particularly for seriously underwater homeowners.[56] For many, default is the "in-the-money" option by any objective measure. Yet most seriously underwater homeowners aren't walking away, even as they sink deeper into negative equity.

III. EXPLAINING HOMEOWNER CHOICES

It might be tempting to label such underwater homeowners "woodheads," a term sometimes applied in economic literature to individuals who choose not to act in their own self-interest.[57] But labeling such behavior irrational does little to explain its existence. One possible explanation is that the low rate of strategic default is not the result of irrational decision making at all, but rather the result of utility-maximizing calculations by homeowners. In other words, it could be that underwater homeowners generally understand that they could save hundreds of thousands of dollars by defaulting on their mortgages, but they simply value their homes (in which they may have "made large financial, emotional, and psychological investments") more than the market does.[58] The "market value" of a home may be, for example, $198,000, but it could be worth $355,000 to the homeowner—indeed why else would he pay that much for it in the first place?[59] Additionally, homeowners as a class may be risk-averse, meaning that they value the security of their good credit and the knowledge that they will not suffer a deficiency judgment or a large tax bill (even if the risk of either is low) more than they value the money that they could save by

and Debt Cancellation, IRS.GOV, http://www.irs.gov/individuals/article/0,,id =179414,00.html (last visited Oct. 9, 2010). This provision applies to debt forgiven in calendar years 2007 through 2012. *Id.*

56. As discussed above, a significant portion of homeowners fall into the "seriously underwater" category. For example, 47% of homeowners in Nevada had negative equity exceeding 25% of their home's value, as did 30% of homeowners in Florida, 29% in Arizona, and 25% in California. *Second Quarter Negative Equity Summary*, *supra* note 1. Given the high median home prices at the peak within these markets, a large percentage of these homeowners are underwater by hundreds of thousands of dollars.

57. *See, e.g.*, Deng & Quigley, *supra* note 6, at abstract.

58. Lauren Ross, The Internal Costs of Foreclosure: A Qualitative Study Exploring Issues of Trust, Insecurity, and Self in the Face of Foreclosure 9 (Aug. 31, 2009) (unpublished M.A. thesis, George Washington University) (on file with author).

59. *See* Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES, Sept. 6, 2009, (Magazine), at MM36 (discussing a general belief among neoclassical economists "that bubbles just don't happen" and quoting Eugene Fama, "the father of the efficient-market hypothesis," as follows: "'[T]he word 'bubble' drives me nuts . . . . Housing markets are less liquid, but people are very careful when they buy houses. It's typically the biggest investment they're going to make, so they look around very carefully and they compare prices. The bidding process is very detailed'").

defaulting. Finally, homeowners as a class may value not having to move more than they value the thousands of dollars they could save by walking away and renting.[60] As one economist has argued, "The so-called 'underexercise' of the default option, therefore, is actually rational behavior without transaction costs . . . ."[61]

This explanation naïvely—or deliberately—ignores much of what the cognitive sciences tell us about how humans actually make decisions. As behavioral economists understand, humans make decisions in ways that are less than fully rational but are understandable given the ways that humans (mis)perceive and (mis)process information.[62] On a basic level, most humans have difficulty doing mathematical calculations and are easily overwhelmed, for example, by the variety of factors that one must consider in deciding the financial benefits and costs of strategically defaulting.[63] Humans are also susceptible to what behavioral economists call the status quo bias—the tendency to keep one's head in the sand.[64] This bias means that even those humans who could do complex calculations if they wanted, usually don't. Moreover, humans suffer from other cognitive biases such as myopia, or the tendency to overvalue up-front cost and undervalue long-term gain.[65] Thus, most underwater homeowners may fail to cognitively grasp the full benefit of strategic default.

Additionally, like all human beings, homeowners suffer from selective perception,[66] which causes them to fail to see evidence,

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60. For support of such a suggestion, see Ross, *supra* note 58, at 10 (discussing the ontological security of homeownership and arguing that "the home offer[s] individuals a sense of order, continuity, and place or physical belonging").

61. Kerry D. Vandell, *Handing Over the Keys: A Perspective on Mortgage Default Research*, 21 J. AM. REAL EST. & URB. ECON. ASS'N 211, 236 (1993).

62. *See, e.g.*, Bar-Gill, *supra* note 53, at 1122 (discussing the effects of human limitations on attention, memory, and processing ability, which lead to less-than-rational decisions, such as simply ignoring critical details in mortgage contracts when confronted with complex calculations).

63. *See, e.g.*, Ubel, *supra* note 7 (positing that human nature, when confronted with financial decisions involving detailed mathematics, is to disregard legitimate financial fears and follow the advice of others, such as real estate agents).

64. *See* Mario J. Rizzo & Douglas Glen Whitman, *Little Brother Is Watching You: New Paternalism on the Slippery Slopes*, 51 ARIZ. L. REV 685, 686 (2009) (attributing human irrationality in part to status quo bias). *See generally* William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988).

65. *See generally* R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23 REV. ECON. STUD. 165 (1956) (discussing myopia); Lester C. Thurow, *Cash Versus In-Kind Transfers*, 64 AM. ECON. REV. 190 (1974) (discussing cognitive biases). *See* Barak Y. Orbach, *Unwelcome Benefits: Why Welfare Beneficiaries Reject Government Aid*, 24 LAW & INEQ. 107, 122 (2006) (discussing myopia in welfare recipients, resulting in a preference for cash equivalents over noncash benefits).

66. Ubel, *supra* note 7 (labeling the human susceptibility to selective

such as actual prices of sold homes in their neighborhood, that would suggest a steep fall in their home's value.[67] Instead, they see contrary indicators such as the list prices of overpriced homes in their neighborhood, which, taken out of context, suggest that prices have not fallen significantly. Selective perception also causes homeowners to fail to attend to estimates on websites such as Zillow.com or fhfa.gov that show that their home is declining in value and to discount media reports of steep price declines as somehow inapplicable to their unique home or to their special neighborhood.[68] Relatedly, homeowners tend toward optimistic overconfidence[69]—believing, for example, that home prices will bounce back in a few years and that their homes will soon be worth more than they paid.[70] Indeed, selective perception may have caused many homebuyers to ignore signs of the impending housing-market collapse in the first place, and optimistic overconfidence may have caused many homeowners to take out interest-only adjustable-rate mortgages ("ARMs") in the misplaced belief that they would have better salaries in a few years or would refinance as their home's value grew exponentially.[71]

There is certainly much in this behavioral economic account that helps explain the choices of underwater homeowners. Many homeowners do tend to overvalue their homes, particularly if they bought them during booms.[72] Many homeowners also have their

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perception as "unrealistic optimism").

67. *See* Chris Dillow, *Housing Over-Confidence*, INVESTORS CHRON. (Apr. 27, 2009), http://www.investorschronicle.co.uk/MarketsAndSectors/Markets/article/20090427/52772fa2-331a-11de-8f90-00144f2af8e8/Housing-overconfidence.jsp ("On hearing that a neighbour's house has sold for a low price, our reaction is often: 'But our house is much more presentable than theirs.' Everyone thinks they are Sarah Beeny. But they are not . . . .").

68. *See id.* (discussing the fact that, due to optimistic overconfidence, sellers generally fail to adequately take price declines into account when setting list prices).

69. *See* Ubel, *supra* note 7 (noting that due to "unrealistic optimism," homeowners overestimated the future growth of their salaries and home values).

70. An analogy here would be the reluctance of many investors to sell a share that drops significantly in value after they bought it and wait in hopes that the share will climb back up to the initial purchase price, even though there may be little hope of it doing so. *See* Whitney Tilson, *Never Too Late To Sell*, MOTLEY FOOL (Mar. 20, 2001), http://www.fool.com/news/foth/2001/foth010320.htm (discussing investor reluctance to sell underperforming stock in the overoptimistic hope of recouping their original investment).

71. *See* Dillow, *supra* note 67 (discussing the distorting effect on prices of the irrational belief that house prices would continue to rise).

72. *See id.* ("[T]he average person over-estimates the price of their house by between five and ten per cent. But there's variation around this average. Whereas people who bought in recessions tend to value their houses accurately, those who bought in booms are even more over-optimistic, overvaluing their properties by up to 20 per cent. . . . There are strong cognitive biases causing this—and not just plain wishful thinking. One is the availability heuristic

heads in the sand, preferring to focus on things that they believe they can control rather than things that they believe they cannot.[73]

On the other hand, labeling the status quo bias, selective perception, and optimistic overconfidence as "cognitive biases" doesn't account for the way in which emotions unconsciously color the perceptions of individuals who want, or need, to believe something—including, for example, that their houses were worth what they paid.[74] As a large body of work in the neurosciences has revealed, much of what passes for cognitive bias is actually emotional bias, reached through no cognitive process whatsoever.[75]

effect. If your biggest exposure to housing market economics came when you bought during a boom—and of course, many more people buy in booms than slumps—rapid house price appreciation will loom large in your mind. This will cause you to over-estimate its size and frequency, and so over-estimate your own house price.").

73. *See supra* note 64 and accompanying text. If one accepts that homeowner decisions are the result of cognitive biases, the solution to helping homeowners make better decisions—should policy makers or others actually wish to encourage rational economic behavior by underwater homeowners—is to help homeowners think better. This means providing better information, helping homeowners calculate the benefits and costs of default, and pointing out the cognitive biases that cloud their thinking. Under this line of thinking, homeowners just need a little help in order to behave more rationally.

74. *See* Christoph Merkle, Emotion and Finance—An Interdisciplinary Approach to the Impact of Emotions on Financial Decision Making 14–15 (Feb. 28, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract =1097131 ("[F]eelings act as a selective attentional filter for incoming stimuli. The strong immediate experience of emotion may lead to a crowding out of other goals. Secondly emotion influences the retrieval of information and knowledge from memory." (internal quotation marks omitted)); *see also* R.B. Zajonc, *Feeling and Thinking: Preferences Need No Inferences*, 35 AM. PSYCHOLOGIST 151, 157 (1980) (discussing the strength of emotional judgment).

75. *See, e.g.*, John A. Bargh & Tanya L. Chartrand, *The Unbearable Automaticity of Being*, 54 AM. PSYCHOLOGIST 462, 476 (1999) (concluding that most human action is not the result of cognitive thought but rather of nonconscious reaction); Ralph D. Ellis & Natika Newton, *Introduction*, *in* CONSCIOUSNESS & EMOTION: AGENCY, CONSCIOUS CHOICE, AND SELECTIVE PERCEPTION, at ix, x–xi (Ralph D. Ellis & Natika Newton eds., 2005) (summarizing collected papers addressing the influence of emotion on perception); Zajonc, *supra* note 74, at 155 (positing that most consumer behavior is emotional); *see also* Milton Lodge, Charles Taber & Christopher Weber, *First Steps Toward a Dual-Processing Accessibility Model of Political Beliefs, Attitudes, and Behavior*, *in* FEELING POLITICS: EMOTION IN POLITICAL INFORMATION PROCESSING 11, 28 (David P. Redlawsk ed., 2006) (explaining that emotion "may indeed, be the primary vehicle implicated in motivated reasoning, leading to selective attention, information distortions, and recall biases"); Terry A. Maroney, *Emotional Competence, "Rational Understanding," and the Criminal Defendant*, 43 AM. CRIM. L. REV. 1375, 1404 (2006) ("First, emotion can influence both which stimuli are perceived and how they are perceived. This is first seen through the mechanism of attention. Because emotionally salient stimuli tend to be the ones of greatest significance to one's thriving, they will be attended to disproportionately." (footnote omitted)); Merkle, *supra* note 74, at 14–15 ("Attention is focused on aspects of a situation that are consistent with the prevailing emotion, what [sic] may result in different estimations of

In other words, when one is consciously or unconsciously motivated to reach a certain conclusion, the brain's emotion systems focus awareness on information that is congruent with one's emotional need and directs the conscious to ignore, reinterpret, or discount incongruent information.[76] As such, if a homeowner is not emotionally receptive to the idea that his home is worth thousands less than he paid, it may be next to impossible to convince him that he is underwater in the first place, much less that it will take twenty years just to recover lost equity.[77] Similarly, if a homeowner places great emotional stock in his credit score, it may be futile to try to convince him that a few years of poor credit is not a big deal. Indeed, trying to persuade the homeowner that he is wrong is likely to make him stick even more firmly to his prior beliefs.[78]

Thus, if one is to understand how homeowners think, one must understand how they feel. Most mortgage default risk modeling fundamentally fails to appreciate this point and more generally does not account for the primacy of emotion in driving human behavior and decision making. This may not matter if the goal is to merely describe or model observable human behavior, but it does matter to the extent that policy makers and others are interested in encouraging individuals to make different choices—or to continue to make the same choices for that matter. In most studies of homeowner decision making, however, emotions are treated as an X-factor to be calculated *around* in figuring out how other varying factors affect individual choice and market behavior.[79] Emotion is rarely considered in and of itself as a primary factor motivating both people and markets. For example, default-risk analysts have studied the relationships between initial loan-to-value ratios and mortgage default,[80] current equity and mortgage default,[81]

probabilities for certain events or a different rating of an alternative's global attractiveness.").

76. *See* Lodge, Taber & Weber, *supra* note 75, at 28–29.

77. *See* Ross, *supra* note 58, at 38 ("Many individuals are reluctant to acknowledge that the housing and mortgage markets have significantly changed and are no longer wholly sustainable or lucrative investments.").

78. David P. Redlawsk, *Feeling Politics: New Research into Emotion and Politics*, *in* FEELING POLITICS: EMOTION IN POLITICAL INFORMATION PROCESSING, *supra* note 75, at 1, 1–2 (explaining that individuals often end up feeling stronger in their beliefs than they did before being confronted with information that would have been expected, under rational models of belief formation, to cause them to reassess their existing beliefs).

79. *See* Vandell, *supra* note 61, at 224 (observing that pricing models "all assumed ruthless default whenever the value of the mortgage dropped beneath the value of the property" and ignored "psychological costs"). *But see* Foote et al., *supra* note 17, at 5 (explaining that in their default prediction model the probability of default, guilt, shame, and reduced access to future credit were included in the calculation).

80. *See, e.g.*, Yongheng Deng, John M. Quigley & Robert Van Order, *Mortgage Terminations, Heterogeneity and the Exercise of Mortgage Options*, 68 ECONOMETRICA 275, 280 (2000) (showing that higher default risk is related to

affordability and mortgage default,[82] credit scores and mortgage default,[83] geography and mortgage default,[84] and unemployment and mortgage default[85]—to name a few. But researchers have shown little interest in the relationship between guilt and mortgage default.[86] Nor have they shown any interest in the relationship between fear and mortgage default.

The neglect of emotion is particularly intriguing given Luigi Guiso, Paola Sapienza, and Luigi Zingales's recent work, which found that 81% of homeowners believe that it is immoral to default on a mortgage and that homeowners who hold this attitude are 77% less likely to declare their intention to default than those who do not.[87] Indeed, once the equity shortfall exceeds 10% of a home's value, the study found that "moral and social considerations" are the "most important variables in predicting the likelihood of a strategic default."[88] So strong are these variables, in fact, that only 17% of homeowners indicated that they would default if the equity shortfall reached 50%.[89] On the other hand, the study found that people who know someone who has strategically defaulted are 82% more likely to declare their intention to default.[90] The authors thus caution that "a policy aimed at helping people in arrears with their mortgage could have devastating effects on the incentives to strategically default of people who can afford to pay their mortgage if it is perceived to bail out people unjustly and thus undermine the moral

higher initial loan-to-value loans).

81. *See generally, e.g.*, Neil Bhutta, Jane Dokko & Hui Shan, Depth of Negative Equity and Mortgage Default Decisions (Div. of Research & Statistics & Monetary Affairs Fed. Reserve Bd., Fin. & Econ. Discussion Series, Paper No. 2010-35, 2010), *available at* http://www.federalreserve.gov/pubs/feds/2010/201035/201035pap.pdf.

82. *See, e.g.*, Foote et al., *supra* note 17, at 3–13.

83. *See generally* Satyajit Chatterjee, Dean Corbae & José-Víctor Ríos-Rull, A Theory of Credit Scoring and Competitive Pricing of Default Risk (Sept. 2007) (unpublished manuscript), *available at* http://pier.econ.upenn.edu/Events/scorevictor.pdf.

84. *See, e.g.*, Deng, Quigley & Van Order, *supra* note 80, at 294–303.

85. *See, e.g.*, *id.* at 290 (finding that trigger events, such as unemployment and divorce, have a significant impact on homeowners' exercise of the default option).

86. While it may seem obvious that one who feels guilty about the idea of defaulting will be less likely to do so, it is equally obvious that those with high loan-to-value ratios, the unemployed, and individuals with low credit scores will be more likely to default. But economists study these things anyway in order to determine how much they matter and how predictive they are of mortgage default. Such information is used by economists to assist lenders in assessing risk and pricing mortgages, but it also informs public policy by purporting to illuminate the most efficient ways to reduce foreclosures.

87. Guiso, Sapienza & Zingales, *supra* note 16, at 19, 21.

88. *Id.* at 18–19.

89. *Id.* at 21.

90. *Id.* at 21–22.

commitment to pay."[91]

While the study sheds important light on the role of social and moral constraints in the default decision, its conclusion also highlights the problem with crafting public policy on the basis of studies that do not try to understand *why* people act the way that they do. Perhaps the authors are right; perhaps people will respond to loan modification programs for those who can no longer afford their mortgages by defaulting on their own mortgages, but there is no evidence to suggest that this is the case. One might just as easily assert that the failure of banks to modify loans for individuals in need, while banks themselves have been bailed out by the federal government, will cause individuals to conclude that they should forget about morals and just look out for their own self-interests.[92] In order to know whether either of these assertions is true, one needs to understand how moral beliefs and attitudes are formed, and one needs to understand how humans make decisions. As evidence from the cognitive sciences convincingly demonstrates, emotion is primary to both.[93]

The Guiso, Sapienza, and Zingales study does, however, confirm something that policy makers and lenders already know and use to their advantage: people are less likely to default if doing so will make them feel like immoral or irresponsible persons, and are especially unlikely to default if they believe others will think of them as immoral or irresponsible persons.[94] Guilt and shame are powerful motivators,[95] and there is no doubt that many people who

91. *Id.* at 3. Indeed, one thrust of the paper is that President Barack Obama's administration's plan to encourage modification of loans to make them more affordable is misguided and likely to backfire. *Id.* at 21.

92. For an example of one individual who feels this way, see LSerbanescu, Comment to *Mortgage Defaults in America: Can Pay, Won't Pay: It Is Easier to Dump a Home Loan If a Friend Has Done So Too*, ECONOMIST (June 27, 2009, 10:02 PM), http://www.economist.com/businessfinance/displayStory.cfm?story_id=13905502&mode=comment&#commentStartPosition ("The financial system created the house market bubble, putting everyone that wanted a house in the uncomfortable position of paying inflated prices. The financial establishment made tons of money in the process. . . . Now that ditching a mortgage makes economic sense for a homeowner, The Economist discovers that such behavior is immoral. . . . [W]hy should anyone be morally obliged to continue to pay [inflated home prices] at a loss?").

93. *See supra* notes 75–76 and accompanying text.

94. Guiso, Sapienza & Zingales, *supra* note 16, at 3 ("Moral norms, if widespread, may strongly mitigate the likelihood that American households will default on their mortgage . . . ."). Research in social psychology has shown that humans invest significant emotional stake in "face"—or their claimed identity as a competent, intelligent, or moral person—and will go to great lengths to avoid actions that publicly threaten this identity. *See, e.g.*, Holley S. Hodgins & Elizabeth Liebeskind, *Apology Versus Defense: Antecedents and Consequences*, 39 J. EXPERIMENTAL SOC. PSYCHOL. 297, 297 (2003).

95. *See* Danielle Einstein & Kevin Lanning, *Shame, Guilt, Ego Development, and the Five-Factor Model of Personality*, 66 J. PERSONALITY 555, 556 (1998) (explaining that guilt and shame are negative affective states that

have faced foreclosure feel a great deal of both.[96]

As Linda, a single mom in Tampa, explained, "As a mom, I feel like I let my children down . . . . It's a terrible embarrassment, and it's humiliating."[97] Linda is not alone: a recent qualitative sociological study of the internal costs of foreclosure found that feelings of personal failure, shame, and embarrassment dominated the accounts of individuals who had lost their homes to foreclosure.[98] Moreover, such feelings predominated even when individuals were not at fault for their predicament, but were victims of the declining economy or unethical practices by mortgage brokers.[99] And, as further evidence of the shame and guilt felt by those who experience foreclosure, large damage awards for humiliation are common features of successful suits against lenders for wrongful foreclosure.[100]

act as moral voices guiding social activity of individuals).

96. *See* Ross, *supra* note 58, at 37 ("The notion of guilt ascription was also central to these findings. Although many individuals recounted the exact ways in which they were 'misled' in their loan negotiations, they often returned to the idea of being personally responsible for their actions.").

97. Judi Hasson, *Homeowners Who Just Walk Away*, MSN MONEY (Apr. 9, 2008), http://articles.moneycentral.msn.com/Banking/HomeFinancing/HomeownersWhoJustWalkAway.aspx.

98. Ross, *supra* note 58, at 37–38.

99. *See id.* at 35–38. One woman in the study described her sense of "utmost responsibility to make her monthly payments on time" saying, "I made a commitment to pay my loan and I want to pay my loan. I'm a hard working person and I want to make good on my loan, but there's no way I possibly can in the situation the economy's in right now." *Id.* at 35. Others expressed concern over being perceived as "irresponsible citizens" or "burdens on society":

> And um so I'm just, I'm kind of interested in the public perception. You know I don't want to be a burden on the rest of society because I'm not paying my mortgage. Now there's this big giant bailout and I'm involved in that. You know, my mortgage was one of the mortgages not being paid.

Id.

100. *See, e.g.*, Carter v. Countrywide Home Loans, No. 3:07CV651, 2009 WL 1010851, at *4 (E.D. Va. Apr. 14, 2009) (allowing claims for humiliation and damage to reputation due to wrongful foreclosure under the Real Estate Settlement Procedures Act ("RESPA") and the Fair Debt Collection Practices Act ("FDCPA")); Brannon v. Bridge Capital Corp., No. 1:06cv996-MHT, 2008 WL 2225791, at *2 (M.D. Ala. May 27, 2008) (discussing plaintiff's claim that "foreclosure publishings caused him embarrassment and humiliation"); Lee v. Javitch, Block & Rathbone, LLP, No. 1:06-cv-585, 2008 WL 1886178, at *2 (S.D. Ohio Apr. 25, 2008) (noting that claim for humiliation from wrongful foreclosure is recoverable under the FDCPA), *rev'd on other grounds*, 601 F.3d 654 (6th Cir. 2010); Clark v. West, 395 S.E.2d 884, 885 (Ga. Ct. App. 1990) (holding mortgagor's obtaining cancellation of foreclosure sale in equitable action did not bar her from pursuing separate claim of damages for humiliation and emotional distress for the alleged intentional, wrongful foreclosure by mortgagees); Levine v. First Nat'l Bank of Commerce, 917 So. 2d 1235, 1243–45 (La. Ct. App. 2005) (holding evidence was sufficient to support award to mortgagor of $150,000 for humiliation and embarrassment and $150,000 for mental anguish); Cushing & Dolan, PC v. Nat'l Lenders, Inc., No. 0105215, 2004 WL 2712208, at *2 n.4

While no study to date has sought to quantify the role of the desire to avoid guilt and shame in underwater homeowners' decisions not to strategically default, more general studies on the role of guilt and shame in motivating human behavior suggest that there is a significant impact.[101] The desire to avoid guilt and shame cannot, however, completely explain the reluctance of homeowners to default. Indeed, the Guiso, Sapienza, and Zingales study found that only 41% of individuals with no moral issue with strategic default would strategically default at $100,000 in negative equity.[102] The question is thus: What keeps the other 59% from walking? Guiso, Sapienza, and Zingales theorize that even "amoral" people may be deterred from defaulting by the social stigma that comes with foreclosure.[103] They are probably right—up to a point. But their study did not actually ask these "amoral" individuals what keeps them from walking away. At some point—if not $100,000 then $200,000 (where 41% of the "amoral" individuals still would not walk)[104]—social stigma alone becomes an unconvincing explanation.

Moreover, foreclosure rates are considerably lower than would be suggested by the Guiso, Sapienza, and Zingales study, as the percentage of people who actually default is much lower than the percentage that indicated they would default in the survey, moral qualms or not. For example, the study found that 26% of individuals would default at $100,000 in negative equity and 41%

(Mass. Super. Ct. Nov. 1, 2004) (recognizing claim for "humiliation" due to "public notices of foreclosure on their home and the inspection of their home by potential buyers, lawyers, and auctioneers"); Volk v. Wis. Mortg. Assurance Co., 474 N.W.2d 40, 44 (N.D. 1991) (recognizing plaintiff's claim for damage to "personal reputation, credit rating, [and] financial reputation, [and injuries as a result of] unfavorable publicity, embarrassment, humiliation, and ridicule caused by the foreclosure action"); Union Fed. Sav. Bank v. Hale, Nos. 16209, 16211, 1993 WL 488399, at *5 (Ohio Ct. App. Nov. 17, 1993) (reciting defendant's allegations that "as a result of Plaintiff's wrongful refusal to accept the aforementioned mortgage payments, I have suffered damage to my credit rating and reputation; emotional distress, anxiety, embarrassment, humiliation and worry"); Mason v. Chase Bank, N.A., No. 05-07-01513-CV, 2008 WL 3412212, at *1 (Tex. Ct. App. Aug. 13, 2008) (noting plaintiff's claim for damages for humiliation from attempted foreclosure).

101. *See, e.g.*, CARROLL E. IZARD, HUMAN EMOTIONS 421–52 (1977) (explaining that guilt is the primary motivational factor in a mature conscience); Damien Arthur & Pascale Quester, *Who's Afraid of That Ad? Applying Segmentation to the Protection Motivation Model*, 21 PSYCHOL. & MARKETING 671 (2004) (demonstrating the importance of fear in determining behavior); Dwight Merunka et al., *Modeling and Measuring the Impact of Fear, Guilt and Shame Appeals on Persuasion for Health Communication: A Study of Anti-Alcohol Messages Directed at Young Adults* (Euromed Marseille Ecole de Management, Working Paper No. 04-2007, 2009), *available at* http://ssrn.com/abstract=963593 ("Shame motivates social behavior and leads to conformity to social norm.").

102. Guiso, Sapienza & Zingales, *supra* note 16, at 10.

103. *Id.* at 8–9.

104. *Id*. at 10.

would do so at $200,000.[105] But given the number of homeowners who are significantly underwater, one would that expect foreclosure rates should be higher if this were the case.

The voices of those who have actually faced foreclosure suggest another powerful emotion that may be keeping homeowners from defaulting: fear. Indeed, the term commonly used to describe foreclosure by those who face it is "terrifying."[106] As one commentator on foreclosure has noted, "Foreclosure is that terrifying word no homeowner ever wants to hear, let alone experience."[107] People not only fear losing their homes, but also fear having ruined credit for life and not being able to find a decent place to live, to buy a car, to get a credit card, to get insurance, to ever buy a house, or even to get a job. Foreclosure is seen as the end of life as one knows it—financial suicide to be avoided at all costs.[108] In short, fear, like shame and guilt, is a powerful motivator in homeowner decisions not to default.[109]

Further empirical study is necessary to comprehend the statistical significance of shame, guilt, and fear in homeowner decisions to strategically default. But all three play a critical role in motivating human behavior and deserve further academic study in the mortgage default context.[110] Academics and nonacademics alike, however, intuitively understand the power of these emotions to

105. *Id.* at 17.

106. *See* John Leland, *Facing Default, Some Abandon Homes to Banks*, N.Y. TIMES, Feb. 29, 2008, at A1 (reporting homeowner terror of foreclosure); *Las Vegas Military Wife Fights To Save Home*, 8NEWSNOW.COM (Aug. 20, 2009), http://www.lasvegasnow.com/Global/story.asp?S=10965954 (describing "terrifying fight" to save home).

107. Jenny Greenleaf, *About Foreclosure Law*, EHOW, http://www.ehow.com/about_4571547_foreclosure-law.html (last visited Oct. 9, 2010).

108. Of course, to argue that homeowner decisions not to default are motivated by fear is not to suggest that cognitive biases play no role. The two are not mutually exclusive but rather are mutually reinforcing. Much homeowner fear is driven by the misperception or overestimation of the future costs associated with foreclosure, and this fear in turn leads to further selective perception and wishful thinking about the probability of housing prices returning to previous levels.

109. *See, e.g.*, Arthur & Quester, *supra* note 101, at 693 (confirming the positive relationship between fear and persuasion); Irving L. Janis & Seymour Feshbach, *Effects of Fear-Arousing Communications*, 48 J. ABNORMAL & SOC. PSYCHOL. 78, 78 (1953) (finding that appeals to fear influence attitudes and behavior); Michael S. LaTour & Herbert J. Rotfeld, *There Are Threats and (Maybe) Fear-Caused Arousal: Theory and Confusions of Appeals to Fear and Fear Arousal Itself*, 26 J. ADVERTISING 45, 47–50 (1997) (observing that fear motivates behavior).

110. For studies of the role of guilt, shame, and fear in motivating behavior in other contexts, see generally, for example, Arthur & Quester, *supra* note 101 (demonstrating the power of negative emotions of fear, guilt, and shame in marketing); Ken Chapman, *Fear Appeal Research: Perspective and Application*, 3 AM. MARKETING ASS'N SUMMER EDUCATOR'S CONF. PROC. 1 (1992) (finding that negative emotional responses significantly influence individual behavior).

control human behavior. As such, those who benefit from underwater homeowners' decisions not to default have not waited for statistical proof of the efficacy of those emotions to cultivate them.[111]

IV. THE SOCIAL CONTROL OF THE HOUSING CRISIS

A concern repeatedly voiced by policy makers, economists, and the media is that the "social pressure not to default" will weaken to the point that homeowners will begin to walk in droves.[112] Of particular concern is the contagion effect—the notion that once a few people in a neighborhood walk, others will follow, until whole neighborhoods end up as empty wastelands.[113] Indeed, geographical patterns already show that foreclosures cluster in neighborhoods,[114] suggesting that once foreclosure is seen as acceptable within a given community, and an individual knows others who have survived foreclosure, there may be less reason to feel ashamed of one's decision to walk or to fear the consequences.

Alarmed by the possibility that foreclosures may reach a tipping point, formal federal policy has aimed to stem the tide of foreclosures through programs designed to "reduce household cash flow problems," such as the Making Home Affordable ("MHA") loan modification program[115] and Hope for Homeowners.[116] Implicit in this approach is the assumption that homeowners are unlikely to default on their mortgages if they can "afford" the monthly

111. *See* Rashmi Dyal-Chand, *Human Worth as Collateral*, 38 RUTGERS L.J. 793, 820 (2007) ("Credit card lenders . . . do seem to recognize the power of shaming their borrowers, though they may not explicitly describe it as such.").

112. *See* Guiso, Sapienza & Zingales, *supra* note 16, at 2, 22 (reporting that "strategic defaults may produce contagion effects" and that policy makers should worry that these contagion effects will weaken social pressure not to default and result in a higher rate of strategic default).

113. *See id.*; John P. Harding, Eric Rosenblatt & Vincent W. Yao, *The Contagion Effect of Foreclosed Properties*, 66 J. URB. ECON. 164, 174 (2009) (noting that "nearby distressed property has a significant, negative effect on the prices of nearby homes over and above the overall trend in market prices").

114. *See* Guiso, Sapienza & Zingales, *supra* note 16, at 6.

115. *See About Making Home Affordable*, MAKINGHOMEAFFORDABLE.GOV, http://makinghomeaffordable.gov/about.html (last visited Oct. 9, 2010) (explaining that the Making Home Affordable program "provides eligible homeowners the opportunity to modify their mortgages to make them more affordable").

116. The FHA website describes the Hope for Homeowners program as follows: "Under the program, certain borrowers facing difficulty with their mortgage will be eligible to refinance into FHA-insured mortgages they can afford. . . . [L]enders will be encouraged to write-down the outstanding mortgage principal balances to 90 percent of the new value of the property." *Fact Sheet: FHA To Provide Additional Mortgage Assistance to Struggling Homeowners*, U.S. DEPARTMENT HOUSING & URB. DEV., http://www.hud.gov/fha/home080730.cfm (last visited Oct. 9, 2010).

payments.[117] In other words, federal policy assumes that homeowners are—for the most part—not "ruthless" and won't walk away from their mortgages simply because they have negative equity.[118] Most homeowners walk only when they can no longer afford to stay. As evidence of this fact, only 45% of homeowners said they would walk even if they had $300,000 in negative equity.[119] This percentage drops to 38% among the subset of individuals who believe it is immoral to strategically default on one's mortgage (a subset to which 87% of homeowners belong).[120]

These numbers suggest that the "moral constraint" is a powerful one indeed, and that, for most people, only the complete inability to afford their mortgage would push them to default. On the other hand, the fact that 63% of "amoral" individuals would default at $300,000 in negative equity, and 59% would do so at $200,000,[121] suggests that federal policy can only proceed on the premise that affordability is the prime consideration as long as the moral and social constraints on foreclosure remain strong. The government, along with certain other economic and social institutions interested in limiting the number of foreclosures, thus has an incentive to cultivate guilt and shame in those who would contemplate walking away. Similarly, knowing that guilt and shame alone are not enough to prevent many individuals from defaulting once negative equity is extreme, these same institutions have an interest in increasing the perceived cost of foreclosure by cultivating fear of financial disaster for those who contemplate it.

This is not to say that there is a grand scheme to manipulate the emotions of homeowners, or even that the government and other institutions consciously cultivate these emotional constraints on default.[122] But, to be sure, the predominant message of political, social, and economic institutions in the United States has functioned to cultivate fear, shame, and guilt in those who might contemplate foreclosure. These emotions in turn function as a form of internalized social control, encouraging conformity to the norm of

117. *See* Guiso, Sapienza & Zingales, *supra* note 16, at 19 (finding that 81% of respondents think that it is morally wrong for a homeowner to default on a mortgage when he or she can afford to make payments).

118. *See* Robert B. Avery et al., *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RES. BULL. 621, 623 (1996) (noting that credit-risk models reflect the fact that few borrowers are ruthless).

119. Guiso, Sapienza & Zingales, *supra* note 16, at 27.

120. *Id.* at 10.

121. *Id.*

122. Social control is defined by most contemporary scholars "as attempts, whether intentional or not, by the state or social institutions to regulate or encourage conformity to a set or norms through socialization or through the threat of coercion, or both." K. Viswanath & David Demers, *Introduction: Mass Media from a Macrosocial Perspective*, *in* MASS MEDIA, SOCIAL CONTROL, AND SOCIAL CHANGE: A MACROSOCIAL PERSPECTIVE 3, 9 (David Demers & K. Viswanath eds., 1998).

meeting one's mortgage obligations as long as one can afford to do so.[123]

The clear message to American homeowners from nearly all fronts is that one has a moral responsibility to pay one's mortgage. The message is conveyed not only by political, social, and economic institutions, but by the majority of Americans who believe that voluntarily defaulting on a mortgage is immoral. At the political level, government spokespersons, including President Obama, have repeatedly emphasized the virtue of homeowners who have acted "responsibl[y]" in "mak[ing] their mortgage payments each month"[124] and have lamented the erosion of "our common values" by, for example, those who irresponsibly borrowed beyond their means.[125] The worst criticism has been reserved, however, for those who would walk away from mortgages that they can afford. Typical of such criticism is that of Secretary of the Treasury Henry Paulson, who declared in a televised speech: "And let me emphasize, any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator—and one who is not honoring his obligations."[126]

Paulson's comment is mild, however, compared to the media invective toward those who strategically walk from their mortgages. Such individuals are portrayed as unseemly,[127] offensive,[128] and unethical,[129] and likened to deadbeat dads who walk out on their children[130] or to those who would have "given up" and just handed Europe over to the Nazis.[131]

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123. *See id.* (noting scholarly work that suggests that social control is most effective when "external control comes to be incorporated into the personality of the individual").

124. President Barack Obama, Remarks by the President on the Housing Mortgage Crisis at Dobson High School (Feb. 18, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-mortgage-crisis/.

125. *Id.*

126. Henry M. Paulson, Jr., Sec'y, U.S. Dep't Treasury, U.S. Housing and Mortgage Market Update Before the National Association of Business Economists (Mar. 3, 2008), *available at* http://www.ustreas.gov/press/releases/hp856.htm.

127. *Cavuto: The Deal: Walk Away From Your Home*, *supra* note 2 ("Seems something unseemly about that. . . . Everyone else in the country is trying to pay their mortgages and trying to get things done. They realize in many cases they are underwater. Their mortgage might be worth more than their home . . . . If you have obnoxious kids, walk away from your kids. . . . Seems kind of weird. Don't you think?").

128. *Id*. ("I know you are not looking at the ethics of this; you are a good savvy businessman. But do you find it even a tinge offensive that we are moving away from personal responsibility? If we can't hack it, we bail out of it.").

129. *The Mike Gallagher Show: Youwalkaway.com* (May 1, 2009) (transcript on file with author).

130. *Cavuto: The Deal: Walk Away From Your Home, supra* note 2.

131. *Id*. ("And you know when you enter into an agreement and everyone

There is similarly no shortage of moralizing about the responsibilities of mortgagors. Typical media messages include: "we need a culture of responsible consumers and homeowners";[132] "one should always honor financial obligations";[133] "when you enter into a contract . . . that should mean something";[134] "there was a time . . . when people felt really bad about not paying off a debt";[135] and, "money is more than a matter of numbers. There are ethics involved. Most people feel, or should feel, an obligation to pay their debts."[136] Even sympathy for those who default because of predatory lending is frequently lacking: "We've read too many sob stories in the press about 'predatory lending'—a rare, misunderstood, and vastly exaggerated phenomenon. It's time for the poster children for irresponsibility to get some face time."[137]

Indeed, a homeowner contemplating a strategic default would be hard-pressed to avoid the message that doing so would place him among the most despicable members of society. It is thus not surprising that a large number of media stories about individuals who walk on their mortgages indicate that these individuals ask that their "last name not be used" to protect their privacy.[138] Nobody wants to be indentified as a deadbeat—or, as one commentator describes them, "a blight on our society."[139] Such individuals seek to protect their privacy for good reason, as it is not just the media and the government that act as norm enforcers, but also individuals, as can be seen in the frequent railings on Internet comment boards and blogs about strategic defaulters. In one typical example, "Bob Green," an individual enraged by the story of "Raam," who posted his own story of why he strategically defaulted on his mortgage, wrote:

> Amazing. Simply amazing. The types of speculators like "Raam" and others should be tied to a tree and left to rot. It's these fine people who are going to walk away and leave the

just throws up the keys and says you know it's really tough this month, it's gonna be tough next month . . . declining real estate values, and we are just going to quit. Can you imagine if we all did that . . . going into World War II? . . . The Japanese just kicked our butt at Pearl Harbor, it just looks so overwhelming, and the odds are so daunting and Germany has just taken over all Europe. Man oh man, let's just cease and desist.").

132. Weiner, *supra* note 2.

133. *Id.*

134. *Cavuto: The Deal: Walk Away From Your Home*, *supra* note 2.

135. *60 Minutes: The U.S. Mortgage Meltdown*, *supra* note 2.

136. Pulliam Weston, *supra* note 2.

137. Steven Spruiell, *Obama Pays Bail Money*, NAT'L REV. ONLINE (June 12, 2008), http://article.nationalreview.com/?q=OWJkNGE3ZjIyYTAzOTg0MWJlYmViM2FlZGVjMjY4ZmY=.

138. *See, e.g.*, Jennifer Robison & Hubble Smith, *Buying & Bailing: Walking Away from 'Underwater' Mortgage Has Pitfalls*, LAS VEGAS REV.-J. (Aug. 30, 2009), http://www.lvrj.com/news/56171687.html.

139. Eckhouse, *supra* note 2.

> societal [sic], writ large, on the hook for their problems. Good job Raam—way to take responsibility.[140]

Moreover, a homeowner who turned to any number of credit-counseling agencies would also find little sympathy—and much moralizing—should he announce his plan to walk on his "affordable" mortgage. Gail Cunningham of the National Foundation for Credit Counseling declared, for example, in an interview on NPR: "Walking away from one's home should be the absolute last resort. . . . However desperate a situation might become for a homeowner, that does not relieve us of our responsibilities."[141] Indeed, the uniform message of both government and nonprofit counseling agencies (which are typically funded at least in significant part by the financial industry) is that "walking away" is not a responsible choice[142] and should be avoided at all costs.[143]

140. Bob Green, Comment to *Should You Walk Away From Your Home?*, MINTLIFE (Jan. 3, 2009), http://www.mint.com/blog/finance-core/should-you-walk-away-from-your-home/. "Raam" tells his story as follows:

> I purchased my first rental property at the age of 21. Everyone said I would make a killing and was really smart for investing so young. I wish I had done more research and seen that we were approaching an inevitable bubble. I bought my first property (a 2-family) for $190k in 2003. Within a year it was valued at double that. After refinancing and putting money into the first property, I bought two more properties the following two years. I had 12 tenants total (being a landlord is no easy task!). The mortgage lenders were pushing ARM's like crazy . . . and they made sense to an investor like me. I needed the lowest monthly payment so I could take the little income left from the rent to put back into the properties. Plus, I could always just refinance my 2-year fixed/28 year adjustable mortgage before the 2 years-fixed were up (refinance to a conventional 30-year fixed) . . . right? Well, taxes went way up. I had a few tenants that cost me over $15k in lost rent (damn tenant-rights laws!), unexpected property damage from frozen water pipes, a couple more bad tenants, and while all this was happening the value of my house secretly dropped below the amount I owed . . . oh sh*t. Then I get a letter in the mail saying my monthly mortgage payments are going to increase by more than $600 a month . . . but wait, I'm already dishing out over $200 a month from my pocket to pay for the properties (assuming all the units are fully rented)! I can't refinance because the value of the property is less than what I owe. I can bust my ass for the next 5-10 years trying to keep up with the payments or I can let everything fall down, file for bankruptcy, and move on. I'm filing. And I'm damn glad. $450k multi-family properties are now for sale at $140k . . . less than I bought my first property in 2003. For me it's easy because they were investment properties, not houses my family lived in (I'm single). I'm renting now and saving as much money as I can, because when things start to turn around I want to be ready, not buried under a million dollars in debt.

Raam, Comment to *Should You Walk Away From Your Home?*, *supra*.

141. Weiner*, supra* note 2.

142. *See, e.g.*, *Foreclosure Prevention FAQs*, FANNIEMAE, http://www.fanniemae.com/kb/index?page=home&c=homeowners

What makes this moral suasion so effective is that major socializing agents in the United States tend to speak with one voice. Thus, when the government, or the credit industry, tells individuals that they have a responsibility to pay their mortgage even if they are seriously underwater, the message is seen as "echoing a deep-seated American belief that one should always honor financial obligations,"[144]—and not as an effort to saddle the primary burden of the housing meltdown on homeowners rather than on the financial industry or the government. More critically, because the media and nonprofit consumer-counseling agencies promote the same message, the government and the financial industry need not bear the primary burden of moral suasion—nor is the message ever identified with those political and economic institutions that have a vested interest in promoting "homeowner responsibility." The message rings true to the ear and, as such, most homeowners question neither the content of the message nor its source.[145]

Social control of would-be defaulters is not limited to moral suasion, however. Predominant messages regarding foreclosure also frequently employ fear to persuade homeowners that strategic default is a bad choice:

> What is real—and what is very much downplayed by these outfits [like YouWalkAway.com]—is how completely a foreclosure wrecks your finances. Near term, you might get slammed with a massive tax bill, since forgiven debt can be subject to income tax. Long term, car loans and—you guessed it—home loans will be much harder to come by. How's that for walking away? "This is the American Dream ended in

_foreclosurepreventionfaqs (last visited Oct. 9, 2010). Fannie Mae answers the question, "Is it best to walk away from my property if I can no longer make the payments?" as follows: "Walking away from your property is not a good choice. Continue to live in your house as long as you are trying to get help from your mortgage company or through a housing counselor." *Id.*

143. U.S. DEP'T OF HOUS. & URBAN DEV., HOW TO AVOID FORECLOSURE (2001), *available at* http://www.hud.gov/offices/adm/hudclips/forms/files/pa426h.pdf (stressing to homeowners that "you should avoid foreclosure if possible" and not "lose your home and damage your credit history"); *see also Default/Foreclosure*, ANAHEIM HOUSING COUNSELING AGENCY, http://www.anaheimhousingcounselingagency.org/id21.html (last visited Oct. 9, 2010) ("Losing your home can be the worst and most devastating event to you personally, and your credit history. This is a scenario that you don't want to occur if you can avoid it!"); *Foreclosure Avoidance Counseling*, U.S. DEPARTMENT HOUSING & URB. DEV., http://www.hud.gov/offices/hsg/sfh/hcc/fc/ (last visited Oct. 9, 2010) ("HUD-approved housing counseling agencies are available to provide you with the information and assistance you need to avoid foreclosure.").

144. Weiner, *supra* note 2.

145. *See generally* JOHN O'SHAUGHNESSY & NICHOLAS JACKSON O'SHAUGHNESSY, THE MARKETING POWER OF EMOTION 61 (2003) (explaining that individuals tend to uncritically endorse information that is in line with their affective predispositions).

> disaster," says Odette Williamson, a foreclosure lawyer at the National Consumer Law Center.[146]

Indeed, almost every media story on those who "walk away from their mortgages" condemns the behavior as immoral and enlists some "expert" to explain that "walking away" is, despite any claims to the contrary, not only immoral but also a devastating event for the homeowner:[147]

> A single missed mortgage payment . . . knocks 100 points off your credit score. Every missed payment thereafter compounds the damage.
>
> A notice of default typically comes after the third missed payment, delivering a knockout blow to the homeowner's credit. . . .
>
> . . . .
>
> The direct effect of any of these outcomes on credit scores is dramatic, and it ripples through every corner of borrowers' financial lives. The former homeowners will be unable to get new credit at reasonable rates, and issuers of their existing credit cards can raise interest rates because they are considered greater risks.[148]

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146. Kiviat, *supra* note 2.

147. *See*, *e.g.*, *id.* ("The whole idea of walking away is troubling to consumer advocates, who worry that these firms are whitewashing the fact that foreclosure is a traumatic experience—both financially and emotionally—that takes years to recover from."). A *Nightline* broadcast warned:

> The thing that homeowners have to take into consideration here is that this is a real disaster for your credit, if you have a foreclosure on your record, even default. But if you fall behind on your mortgage, and don't pay it, everyone you go to borrow money from for the next six or seven years is going to know about this. When you try to go for a job, when you try to rent an apartment, this is going to be on your credit. It's not like you walk away scot-free, you walk away with a huge black mark on your credit rating.

Nightline: The Big Cut (ABC television broadcast Jan. 31, 2008), *available at* http://abcnews.go.com/Video/playerIndex?id=4220208&affil=wxyz; *accord Cavuto: The Deal: Walk Away From Your Home*, *supra* note 2; *Mortgage Defaults in America: Can Pay, Won't Pay*, ECONOMIST (June 25, 2009), http://www.economist.com/node/13905502?story_id=13905502 (recognizing the moral barrier to default); Pulliam Weston, *supra* note 2; *Squawk Box: Santelli's Tea Party* (CNBC television broadcast Feb. 19, 2009), *available at* http://www.cnbc.com/id/15840232?video=1039849853 (emphasizing that defaulting on a mortgage is "bad behavior"); Schoen, *supra* note 2 ("The most important reason [why it's a bad idea to walk away]: You signed a contract, took the money and promised to pay the lender back. That's what the law now requires you to do. . . . [Foreclosure] will ruin your credit rating . . . ."); Spruiell, *supra* note 137; Streitfeld, *supra* note 2; Weiner, *supra* note 2.

148. Hasson, *supra* note 97. With a few notable exceptions, major media

Similar warnings of disaster pervade the information given to homeowners by housing-counseling agencies approved by the U.S. Department of Housing and Urban Development,[149] such as the following from the Anaheim Housing Counseling Agency:

> Losing your home can be the worst and most devastating event to you personally, and your credit history. This is a scenario that you don't want to occur if you can avoid it! Not only will you lose the comfort of your home and your investment, but a Foreclosure will stay pending on your credit history for as long as 10 years. This will jeopardize your ability to qualify for any future home loan purchases, it may affect your ability to access loans for car purchase and other needed purchases, and loan costs are likely to be higher both in fees and interest paid.[150]

As discussed above, fear alone is a powerful motivator. But guilt and fear in combination are even more potent.[151] This may be

coverage of an earlier version of this Article has followed this same script—despite the fact that this script was described in the earlier version of the Article. *See, e.g.*, Kenneth R. Harney, *The Moral Dimensions of Ditching a Mortgage*, WASH. POST, Nov. 28, 2009, at E1 (describing the "incendiary core message" of this Article and quoting Fannie Mae spokesman Brian Faith's response that "there's a moral dimension to [walking away] as homeowners who simply abandon their homes contribute to the destabilization of their neighborhood and community," and Lewis Ranieri's (chief executive of several major mortgage-related companies) criticism of the author as "incredibly irresponsible and misinformed"); Liz Pulliam Weston, *Are You Foolish To Pay Your Mortgage?*, MSN MONEY (Dec. 9, 2009), http://articles.moneycentral.msn.com/Banking/HomeFinancing/Weston-should-you-walk-away-from-your-home.aspx?page=1 (describing this Article and responding that "walking away" is "wrong" and "an assault on our integrity and our character"). For notable exceptions, see Roger Lowenstein, *Just Walk Away: Why Should Underwater Homeowners Behave Any Different from Banks?*, N.Y. TIMES, Jan. 10, 2010, (Magazine), at MM15 (advocating that underwater homeowners consider walking away); and Richard H. Thaler, *Underwater, but Will They Leave the Pool?*, N.Y. TIMES, Jan. 24, 2010, at BU3.

149. *See, e.g.*, *Housing Counseling*, GREENPATH DEBT SOLUTIONS, http://www.greenpath.com/how-we-can-help/housing-counseling.htm (last visited Oct. 9, 2010) ("Greenpath's housing counseling services can help you preserve your most important asset, your home. After all, tenants, homeowners and future home purchasers have a lot to lose if their finances get out of control—and a lot to gain from housing counseling delivered by an unbiased housing counselor.").

150. *Default/Foreclosure*, *supra* note 143; *accord Foreclosure Prevention FAQs*, *supra* note 142 ("Foreclosures are extremely damaging to your credit and may impact your credit rating for as long as seven years. A foreclosure can make it difficult to get a loan for a future home purchase, college expenses, or to get a major credit card. If you are able to get credit, your interest rates will likely be higher. For most people, it is well worth the time and effort to avoid foreclosure."); Weiner, *supra* note 2 (quoting Ellen Schloemer, Director of Research at the Center for Responsible Lending, for the proposition that "[i]t takes a decade to recover from a foreclosure").

151. *See generally* Lauren G. Block, *Self-Referenced Fear and Guilt Appeals: The Moderating Role of Self-Construal*, 35 J. APPLIED SOC. PSYCHOL. 2290

because most individuals have a deep-seated, if ill-defined, sense that if they do "bad things," bad things will happen to them. Whatever the psychological underpinnings, most people simply do not believe they will escape punishment for their moral transgressions. Guilt and fear of punishment go together. Thus, the notion that one will suffer great consequences for walking away from one's financial obligations not only seems possible, but feels quite right. It just can't be that one can walk away from his mortgage with no significant consequence. As such, people rarely question apocalyptic descriptions of foreclosure's consequences.

As explored above, however, there is in fact a huge financial upside to strategic default for seriously underwater homeowners—an upside that is routinely ignored by the media, credit-counseling agencies, and other political and economic institutions when "informing" homeowners about the consequences of default. Moreover, the costs of default are not nearly as extreme as these same institutions typically misrepresent them to be. In reality, homeowners face no risk of a deficiency judgment in many states,[152] or for FHA loans regardless of the state;[153] lenders are unlikely to pursue a deficiency judgment even in recourse states because it is economically inefficient to do so;[154] there is no tax liability on "forgiven portions" of home mortgages under current federal tax law in effect until 2012;[155] defaulting on one's mortgage does not mean that one's other credit lines will be revoked;[156] and most people can expect to recover from the negative impact of foreclosure on their credit scores within a few years[157] (and, meanwhile, a few years of

(2005); Francesco Mancini & Amelia Gangemi, *The Role of Responsibility and Fear of Guilt in Hypothesis-Testing*, 37 J. BEHAV. THERAPY & EXPERIMENTAL PSYCHIATRY 333 (2006); Merunka et al., *supra* note 101 (concluding "that a threatening message implying fear, guilt and shame together might well be the most persuasive"); Kirsten A. Passyn & Mita Sujan, *Self-Accountability Emotions and Fear Appeals: Motivating Behavior*, 32 J. CONSUMER RES. 583 (2006) (arguing that messages that appeal to guilt and fear are more effective deterrents on potentially harmful behavior than positive messages).

152. *See* Andra C. Ghent & Marianna Kudlyak, *Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States* 5 (Fed. Reserve Bank of Richmond, Working Paper No. 09-10R, 2010), *available at* http://ssrn.com/abstract=1432437 (listing Alaska, Arizona, California, Iowa, Minnesota, Montana, North Carolina, North Dakota, Oregon, Washington, and Wisconsin as nonrecourse states).

153. *See id.* at 3 (noting that deficiency judgments are barred for FHA loans).

154. *See* Ralph Roberts, *Top Myths About Loan Modification*, REALTY TIMES (Jan. 26, 2009), http://realtytimes.com/rtpages/20090126_myths.htm; *supra* note 53 and accompanying text.

155. *See supra* note 55 and accompanying text.

156. *See* Silberstein, *supra* note 49 (noting that one may rebound his or her Fair Isaac Corporation score by keeping all other credit obligations in good standing).

157. *See supra* note 50 and accompanying text.

poor credit need not seriously impact one's life).

Homeowners with high credit scores, however, may have an especially hard time accepting the notion that a few years of poor credit is no big deal. The hard-to-convince include the vast majority of homeowners with prime loans—94% of whom had credit scores above 660 when they purchased their homes.[158] Most American homeowners see their good credit scores not only in utilitarian terms (i.e., as helpful in increasing their purchasing power) but also as a "source of pride," or a statement of their good moral character.[159] Indeed, the view that one's credit score reflects one's character, or at least one's sense of responsibility and trustworthiness, is widespread in American culture.[160] This belief is not surprising given that the federal statute that governs credit reporting, the Fair Credit Reporting Act ("FCRA"), describes credit reporting as a "mechanism for investigating and evaluating the credit worthiness, credit standing, credit capacity, *character, and general reputation of consumers.*"[161]

A bad credit score is, by design, meant to reflect not only one's poor creditworthiness, but also one's poor moral character. For individuals to lose their good credit is thus to lose not only "their self-conceptions as people who keep their promises and pay their debts on time,"[162] but part of their "human worth" as well.[163] Even being "perceived as having bad credit"—such as having one's credit card declined at a restaurant—is deeply humiliating to most Americans.[164] A bad credit score is nothing less than a reputational scarlet letter that, because of the "omnipresence of the credit reporting system," follows individuals wherever they go.[165] As a result, Americans engage in a great deal of self-regulation to maintain good credit scores.[166] The lending industry in turn "uses

158. *See* Avery et al., *supra* note 118, at 632 (noting that 93.6% of borrowers with conventional, fixed-rate mortgages have credit scores in the high range, meaning above 660).

159. *See* Dyal-Chand, *supra* note 111, at 815 ("[A] good credit score itself is now something about which to be proud, and a bad credit score is something about which to be ashamed.").

160. *See id.* at 811 n.94 ("[T]here appears to be a growing trend of using credit reports as a proxy for screening and decision-making processes outside the context of credit transactions, and in contexts where character was once assessed in a more holistic manner. For instance, some relationship experts now recommend using credit reports to evaluate the trustworthiness and suitability of a potential romantic partner, while some businesses forego the interview screening process entirely in favor of the information about an individual that may be gleaned from a credit report.").

161. 15 U.S.C. § 1681(a)(2) (2006) (emphasis added).

162. *See* Dyal-Chand, *supra* note 111, at 812.

163. *See generally* Dyal-Chand, *supra* note 111.

164. *Id.* at 815.

165. *Id.* at 809–10.

166. *See id.* at 811–12.

credit scores as a threat" to constrain borrower behavior.[167]

This power to threaten borrowers means that, though mortgage agreements in nonrecourse states contain an implied "put option"—a contractual option to default and transfer ownership of the home to the lender—the law plays a subordinate role in lender-borrower relations. A borrower might in fact walk without *legal* penalty, but the lender holds the borrower's human worth as collateral—and will likely trash it in retaliation for the borrower's exercise of his or her contractual right to default.[168] The credit-reporting system thus subordinates the law to social norms and makes it impossible for a strategic defaulter to avoid the reputational penalty of default, even by packing up and moving across the country. Indeed, for seven years, perfect strangers who access the defaulter's credit report will learn of the moral misdeed and express their disapproval, if only by changing their tone of voice in the way that individuals tend to do when addressing someone of a lesser social status.[169]

In short, although the financial sting of a temporarily poor credit score may be relatively easy to mitigate,[170] the damage to one's reputation and sense of self-worth may be both more intense and more enduring. This reality brings the question back full circle to whether seriously underwater homeowners may be acting in utility-maximizing ways by not walking away from their mortgages. Indeed they may be, if emotional suffering is a mere transaction cost of default. But assessing whether the behavior is utility-maximizing misses the point. The point is that the credit-reporting system operates in conjunction with other economic, political, and social institutions as a means of social control by increasing the emotional cost of default. Moreover, the credit-reporting system operates largely outside of the legal process as a norm enforcer,[171] ensuring

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167. *Id.* at 811.

168. *See id.* at 815 ("In the consumer context, the connection between credit reports, credit, and social status provides a means of eliminating a person's sense of honor. Simply put, by reporting negative information to a credit bureau, a lender can limit a borrower's acquisition of status-enhancing goods and services, and more basically, lower her social standing.").

169. Seven years is the length of time that the fact of the foreclosure remains on an individual's credit report (though its effect on the actual score will effectively disappear long before then). *See* FED. TRADE COMM'N, BUILDING A BETTER CREDIT REPORT 9 (2008), *available at* http://www.ftc.gov/bcp/edu/pubs /consumer/credit/cre03.pdf; Silberstein, *supra* note 49.

170. For example, one might make any purchases for which one will foreseeably need credit before default and use a debit card in place of a credit card for purchases and rental car reservations after default.

171. The credit-reporting system is governed by the FCRA. 15 U.S.C. § 1681 (2006). The "system" consists of a "consumer report," defined by the FCRA as:

> any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living which is used or expected to be used or collected in whole or in part for the purpose of serving as a

immediate reputational punishment for those individuals who might be tempted to flout their "moral commitment to pay" by exercising their legal right to default.

V. THE ASYMMETRY OF HOMEOWNER AND LENDER NORMS

One obvious response to the above discussion is that society benefits when people honor their financial obligations and behave according to social and moral norms, rather than strictly legal or market norms. This may be true if lenders behaved according to the same social and moral norms. In the case of lender-borrower behavior, however, there is a clear imbalance in placing personal responsibility on the borrower to honor his "promise to pay" in order to relieve the lender of its agreement to take back the home in lieu of payment. Given lenders' generally superior knowledge and understanding of both mortgage instruments and valuation of real estate, it seems only fair to hold them to the benefit of their bargain. At a basic level, sound underwriting of mortgage loans requires lenders to ensure that a loan is sufficiently collateralized in the event of default.[172] In other words, in appraising a home, the lender should ensure that the loan amount, at the least, does not exceed the intrinsic market value of the home.

As discussed above, a textbook premise of economics is that a home's value, even that of an owner-occupied one, is "the current value of the rent payments that could be earned from renting the property at market prices."[173] As such, historical home prices have hewed nationally to a price-to-annual-rent ratio of roughly fifteen-to-one.[174] At the peak of the market, however, price-to-rent ratios reached fifty-one-to-one in the most inflated markets, and the national average reached twenty-three-to-one.[175] If personal responsibility is the operative value, then lenders who ignored basic economic principles (of which they should have been aware) should bear at least equal responsibility with homeowners for the foreclosure crisis, as they issued collateralized loans that were far in excess of the intrinsic value of the home.

Moreover, since lenders generally arrange the appraisal (for which homebuyers must pay) and homebuyers rely on the lender to ensure that the home is worth the purchase price,[176] one might

> factor in establishing the consumer's eligibility for credit or insurance . . . or any other purpose [permitted by the FCRA].

Id. § 1681a(d)(1) (footnote omitted).

172. *See, e.g.*, *Mortgage Loan Underwriting*, FIN. WEB, http://www.finweb.com/mortgage-loan-education/mortgage-loan-underwriting.html (last visited Oct. 9, 2010).

173. RHO ET AL., *supra* note 27, at 3.

174. *Id.* at 4 & n.3.

175. *Where Housing Is Headed*, FORTUNE, http://money.cnn.com/magazines/fortune/price_rent_ratios/ (last visited Oct. 9, 2010).

176. *See* James Hagerty, *Reappraising Home Appraisers*, WALL ST. J. (Aug.

argue that lenders should bear much more than 50% responsibility for the bad investment of the homeowner and lender. As Joseph Stiglitz has explained, "[F]or the most part, the lenders were, or should have been, far more financially sophisticated than the borrowers . . . ."[177] Lenders "should [thus] be made to bear the consequences of their failures to assess risk."[178]

Indeed, lenders' mortgage-default-risk models have long shown that the loan-to-value ratio is a critical determinant of default risk.[179] Lender underwriting practices thus traditionally required that homeowners have sufficient equity (usually by requiring a sufficient down payment) such that default would never be the "in-the-money option."[180] Lenders relaxed this requirement, however, as credit-default models showed that few borrowers were "ruthless," meaning that would few borrowers default as soon as the loan value exceeds the market value of the home.[181] Lenders thus moved toward models that relied heavily on credit history as the predictor of default risk. These models showed, for example, that only 0.9% of borrowers with "high" credit scores and 4% of borrowers with "medium" credit scores would default on their mortgages.[182] This led lenders to conclude that default risk was sufficiently low for borrowers with high and medium credit scores that lenders could profitably offer a variety of alternative mortgage products, including zero-down loans, interest-only ARMs, and negative amortization loans.[183]

In other words, lenders lost sight of the importance of positive equity in lowering the risk of mortgage default, and failed to ensure that homes were actually worth what they were being purchased for.[184] This is not to say that lenders are solely responsible for the

18, 2009), http://online.wsj.com/article/SB10001424052970203496804574348712795471006.html ("Appraisals are supposed to shield home buyers from paying too much and lenders from overestimating the value of collateral. If appraisals come in too high, buyers may overpay, making defaults more likely.").

177. Memorandum from Joseph E. Stiglitz, Chair, Comm'n of Experts of the President of the U.N. Gen. Assembly on Reforms of the Int'l Monetary and Fin. Sys. to Comm'n on Foreclosures [hereinafter Memorandum from Joseph E. Stiglitz], *available at* www.un-ngls.org/docs/ga/cfr/memo_foreclosure.pdf.

178. *Id.*

179. Vandell, *supra* note 61, at 215 (citing academic work validating the effect of initial loan-to-value ratio in influencing default).

180. *See id.* at 212–13, 218.

181. *See id.* at 224 (finding that the first option-based models overestimated the ruthless default of homeowners in comparison to that what was actually observable in the market).

182. *See* Avery et al., *supra* note 118, at 632.

183. *See* Vandell, *supra* note 61, at 220–23.

184. *See, e.g.*, *Boom, Bust and Blame – The Inside Story of America's Economic Crisis – By the Numbers*, CNBC.COM, http://www.cnbc.com/id/32756455/ (last visited Oct. 9, 2010) ("Financial institutions big and small got caught up in the lending frenzy. Some were fly-by-night operations that made

housing run-up and bust, but that they do in fact bear a substantial portion of the blame—and thus should bear a substantial portion of the cost.[185] One might argue, in fact, that the value of personal responsibility would require lenders to own up to their share of the blame and work with underwater homeowners by voluntarily writing off some of the negative equity.

But lenders, of course, do not operate according to norms of personal responsibility, and seek instead to maximize profit (or minimize losses). Indeed, to the extent that the lender is a corporation, the directors and executives of the corporation have a legal duty to shareholders to maximize profit and minimize losses.[186] It is this loss-minimizing behavior, in fact, that drives banks to strategically default on their own properties when it is economically efficient to do so (such as Morgan Stanley's highly publicized default on five properties in San Francisco[187] and the Mortgage Bankers Association's short sale of its former building in Washington, D.C.[188]).

This moral double standard aside, it has been suggested that given the great cost of foreclosure to lenders, lenders should have an economic incentive to modify loans for homeowners in danger of default.[189] This argument has flown in the face of the reality,

millions through questionable loans. Others were well-known firms with strong reputations, blinded by the promise of huge mortgage profits."); *Boom, Bust and Blame – The Inside Story of America's Economic Crisis – Subprime Explosion*, CNBC.COM, http://www.cnbc.com/id/31189225 (last visited Oct. 9, 2010).

185. Of course, others share in the blame as well, including mortgage brokers and appraisers who in certain instances conspired to inflate home values. *See, e.g.*, Laura Misjak, *Heintz Mortgage Fraud Case Involved Inflated Property Values in Grand Blanc, Davison*, MLIVE.COM (Feb. 18, 2010), http://www.mlive.com/news/flint/index.ssf/2010/02/heintz_mortgage_fraud_case_inv.html; Larry Neumeister, *41 People in 4 States Charged in Mortgage Fraud*, ABCNEWS, Oct. 15, 2009, http://abcnews.go.com/Business/wireStory?id=8835204. Buyers' real estate agents, who pushed buyers to buy at inflated prices and failed to warn of an impending bust that they knew, or should have known, was coming—or at the very least failed to inform buyers once monthly trends began to show declining prices—are similarly blameworthy. *See* David Streitfeld, *Feeling Misled on Home Price, Buyers Are Suing Their Agent*, N.Y. TIMES, Jan. 22, 2008, at A1.

186. *See* Michael J. O'Hara, *Governing for Genuine Profit*, 36 VAND. J. TRANSNAT'L L. 765, 767 (2003) (delimiting the obligations of the fiduciaries of a corporation).

187. *See* Shahien Nasiripour, *Don't Look Back: Major Players Continue To 'Walk Away' from Poor Mortgages*, HUFFINGTON POST (Jan. 25, 2010), http://www.huffingtonpost.com/2010/01/25/dont-look-back-major-play_n_435965.html.

188. *See* Claire Shipman & Mary Pflum, *Is It Wrong To Walk Away from a Mortgage Deep Underwater?: Debate Grows as Housing Crisis Continues*, ABCNEWS (Feb. 11, 2010), http://abcnews.go.com/GMA/mortgage-defaults-borrowers-walk-away-underwater-home/story?id=9802435.

189. MORTG. BANKERS ASS'N, LENDERS' COST OF FORECLOSURE 4–5 (2008), *available at* http://www.nga.org/Files/pdf/0805FORECLOSUREMORTGAGE

however, that lenders have been reluctant to modify loans, even for borrowers in the preforeclosure process.[190]

Recent studies seeking to explain this apparently irrational behavior have shown that lenders are simply operating to maximize profit and minimize losses, just as they would be expected to do.[191] First, lenders know that borrowers with high credit scores are unlikely to default even at high levels of negative equity.[192] To modify loans for these homeowners would be to throw money away and to encourage more homeowners to ask for modifications. Second, a significant number of homeowners who temporarily default on their mortgages "self cure" without any help from their lender[193]—though self-cure rates have dropped precipitously in the last two years.[194] Again, to modify the loans of individuals who would otherwise self cure would be to throw away money. Third, homeowners who have poor credit, or who end up in arrears because of "triggering events," such as unemployment, divorce, or other financially devastating circumstances, are likely to default on the modified loan as well.[195] To modify loans for these individuals is to waste time and risk housing prices falling further before the lender eventually has to foreclose and sell the property anyway.

Given these economic incentives for the lender, a seriously underwater homeowner with good credit and a solid mortgage

.PDF (explaining that foreclosure is a prohibitively costly exercise for the mortgage industry as it involves significant lost payments on principal and interest, as well as necessitates legal, administrative, and property maintenance fees, all of which are incurred by the lender).

190. *See* Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? The Effect of Securitization* 1–2 (Fed. Reserve Bank of Atlanta, Working Paper No. 2009-17a, 2010), *available at* http://www.frbatlanta.org/documents/pubs/wp/wp0917a.pdf (finding that less than 2% of all delinquent loans receive modification within the first year following delinquency).

191. *See, e.g.*, *id.* at 32; *see also* Foote et al., *supra* note 17, at 1 ("While investors might be foreclosing when it would be *socially* efficient to modify, there is little evidence to suggest they are acting against *their own* interests when they do so.").

192. *See* Avery et al., *supra* note 118, at 632; Foote et al., *supra* note 17, at 12–17.

193. *See* Foote et al., *supra* note 17, at 2 ("Investors also lose money when they modify mortgages for borrowers who would have repaid anyway, especially if modifications are done *en masse*, as proponents insist they should be.").

194. *See* CONG. OVERSIGHT PANEL, *supra* note 1, at 12 (recognizing the decline in self-cure rates).

195. *See* Foote et al., *supra* note 17, at 2 ("Moreover, the calculation [that lenders are acting against their own interest] ignores the possibility that borrowers with modified loans will default again later, usually for the same reason they defaulted in the first place."); *see also* Adelino, Gerardi & Willen, *supra* note 190, at 19 n.25 (noting that unemployment is a very important determinant of a borrower's decision to default); Deng, Quigley & Van Order, *supra* note 80, at 290 (recognizing "triggering events" such as divorce and unemployment as contributing to the default decision).

payment history who responsibly calls his lender to work out a loan modification is likely to be told by his lender that it will not discuss a loan modification until the homeowner is thirty days or more delinquent on his mortgage payment.[196] The lender is making a bet (and a good one) that the homeowner values his credit score too much to miss a payment and will just give up the idea of a loan modification. However, if the homeowner does what the lender suggests, misses a payment, and calls back to discuss a loan modification in thirty days, the homeowner is likely to be told to call back when he is ninety days delinquent.[197] In the meantime, the lender may send the borrower a series of strongly worded notices reminding him of his moral obligation to pay and threatening legal action, including foreclosure and a deficiency judgment, if the homeowner does not bring his mortgage payments current.[198] The lender is again making a bet (and again a good one) that the homeowner will be shamed or frightened into paying his mortgage. If the homeowner calls the lender's bluff and calls back when he is ninety days delinquent, there is a good possibility that he will be told that his credit score is now so low that he does not qualify for a loan modification.[199] The homeowner must then decide whether to bring the loan current or face foreclosure. If the homeowner somehow makes clear to the lender that he has chosen foreclosure, the lender *may* finally be willing to negotiate a loan modification, a short sale, or a deed-in-lieu of foreclosure—all of which still leave the homeowner's credit in tatters (at least temporarily).

Most lenders will, in other words, take full advantage of the asymmetry of norms between lender and homeowner and will use the threat of damaging the borrower's credit score to bring the homeowner into compliance. Additionally, many lenders will only bargain when the threat of damaging the homeowner's credit has lost its force and it becomes clear to the lender that foreclosure is imminent absent some accommodation.[200] On a fundamental level, the asymmetry of moral norms for borrowers and market norms for

196. *See, e.g.*, Edmund L. Andrews, *My Personal Credit Crisis*, N.Y. TIMES, May 17, 2009, (Magazine), at MM46 (describing the author's efforts to renegotiate his mortgage with his lender).

197. *See, e.g.*, *id*.

198. *See* Marlon Baugh, *The Notice of Default – This Is When a Foreclosure Begins*, EZINE ARTICLES, http://ezinearticles.com/?The-Notice-of-Default—-This-is-When-a-Foreclosure-Begins?&id=3303141 (last visited Oct. 9, 2010) (discussing the letters lenders send to scare borrowers into paying their mortgage).

199. *See How Banks View Loan Modifications*, MANDELMAN MATTERS, http://mandelman.ml-implode.com/2009/11/how-banks-view-loan-modification/ (last visited Oct. 9, 2010) (giving an anecdotal account of how banks treat borrowers who seek to modify their loans).

200. *See* Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications*, 41 CONN. L. REV. 1107, 1113–14 (2009).

lenders gives lenders an unfair advantage in negotiations related to the enforcement of contractual rights and obligations, including the borrower's right to exercise the "put option." This imbalance is exaggerated by the credit-reporting system, which gives lenders the power to threaten borrowers' human worth and social status by damaging their credit scores—scores that serve as much as grades for moral character as they do for creditworthiness.[201] The result is a predictable imbalance in which individual homeowners have borne a huge and disproportionate burden of the housing collapse.

VI. LEVELING THE PLAYING FIELD

While the federal government has given billions to bail out financial institutions,[202] the primary assistance that it has offered to underwater homeowners has been allowing them to refinance up to 125% of their home's current value at today's lower interest rates, if they are current on their mortgage and their original loan was insured by Freddie Mac or Fannie Mae.[203] Additionally, for homeowners who are "at risk of imminent default," the Treasury Department has encouraged lenders to voluntarily modify loans so that borrower payments do not exceed 31% of their total monthly income.[204] In order to incentivize such loan modifications, the Treasury Department has offered lenders $1000 for each eligible mortgage they modify, plus $1000 per year for three years as long as the borrower remains in the program.[205] Additionally, once the lender has absorbed the cost of reducing the monthly debt-to-income ratio to 38%, the Treasury Department will share the cost, dollar-for-dollar, of reducing the ratio further to 31%.[206]

Government policy makers have premised this approach on two central tenets: (1) that the key to preventing foreclosures is to ensure that mortgage payments are affordable; and (2) that the severity of the foreclosure crisis in the United States is due in large part to lenders' unwillingness to renegotiate mortgages to make them more affordable.[207] Policy makers have grounded this single-minded focus of affordability on studies from earlier, less severe,

201. *See supra* notes 159–69 and accompanying text.
202. *See History of U.S. Gov't Bailouts*, PROPUBLICA, http://www.propublica.org/special/government-bailouts (last visited Oct. 9, 2010).
203. Press Release, U.S. Dep't of Hous. & Urban Dev., HUD Secretary Donovan Announces Expanded Eligibility for Making Home Affordable Refinancing (July 1, 2009), *available at* http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2009/HUDNo.09-104.
204. *See* Memorandum for U.S. Dep't of Treasury on Making Home Affordable 3–4 (Mar. 4, 2009) [hereinafter Making Home Affordable Memo], *available at* http://www.treas.gov/press/releases/reports/housing_fact_sheet.pdf.
205. *Id.* at 4.
206. *Id.*
207. *See* Adelino, Gerardi & Willen, *supra* note 190, at 1.

housing busts that showed that borrowers with affordable mortgages rarely default.[208]

There are several problems, however, with focusing on affordability alone as the key to averting the worsening of the foreclosure crisis. First, government programs have defined "unaffordable" as a total monthly payment exceeding 30% of one's gross monthly income.[209] This arbitrary cutoff does not account for the reality that even if one's payment doesn't exceed 30% of one's gross monthly income, paying, for example, $3000 a month for a home that could be purchased or rented today for around $1000 a month is financially unwise. Or as "economists might argue . . . an unaffordable mortgage is one that is really too expensive, in the sense that the benefits that come with making payments on the mortgage no longer outweigh the opportunity costs of doing so."[210] To account for this fact, "affordable" might instead be defined not only according to one's gross income, but also in relation to the fair rental value of one's home. A home that costs three times more to own than it would to rent would be by definition unaffordable. On the other hand, a home that costs less to own than it would to rent might be not too expensive even if the payment exceeds 30% of one's gross monthly income, as long as one could make the payment with room to spare.

Conversely, paying 30% of gross monthly income for a mortgage will leave many middle-to-low-income individuals with little to spare, especially if those individuals have other significant financial obligations, such as child care or medical bills. Indeed, leaving aside monthly budget concerns, 30% (or even 20%) of one's income is a significant percentage if the payment is essentially being thrown away into a large negative-equity hole out of which one is not likely to dig. Once a home has become an albatross instead of an investment, struggling to pay a mortgage makes no financial sense, almost regardless of one's monthly payment. For many homeowners, technical affordability is not the lone consideration. Relative affordability and negative equity both matter as well—and once negative equity is severe enough, it may overwhelm other considerations.

Recognizing this reality, a number of proposals have been put forth to address the relative affordability and negative equity problems. Joseph Stiglitz has suggested, for example, that the government should itself become a lender and issue mortgages at low interest rates, which would help address the relative

208. *See* Guiso, Sapienza & Zingales, *supra* note 16, at 5.

209. *See, e.g.*, *Affordable Housing*, U.S. DEPARTMENT HOUSING & URB. DEV., http://www.hud.gov/offices/cpd/affordablehousing/index.cfm (last visited Oct. 9, 2010) ("The generally accepted definition of affordability is for a household to pay no more than 30 percent of its annual income on housing.").

210. *See* Foote et al., *supra* note 17, at 4.

affordability issue and partially compensate for negative equity.[211] Others have suggested that the government use stimulus funds to buy down underwater mortgages[212] or assist homeowners through grants that would cover a portion of their payments.[213] Each of these proposals would bring some balance to the government's current approach to the mortgage crisis by providing direct assistance to homeowners, as opposed to injecting money into the banking system in hopes that some of the benefit will trickle down in the form of greater credit availability. Equally as important, these proposals would circumvent the problems created by norm asymmetry between borrowers and lenders because borrowers could go to the government for help regardless of their lender's willingness to renegotiate.

In contrast to a government bailout of underwater homeowners, other proposals would force lenders to write off some of the principal of underwater mortgages without the government picking up the tab. For example, Adam Levitin has proposed allowing bankruptcy judges to write down mortgages on primary residences,[214] which is prohibited under current bankruptcy law.[215] This proposal, too, is a step in the right direction in that it would help compensate for the problems of norm asymmetry by eliminating the need for borrowers to negotiate with lenders. However, Levitin's proposal would help only underwater homeowners who qualified for bankruptcy and

211. Stiglitz has argued that such a program would allow the government to earn a return on these mortgages and incentivize the mortgage industry to compete by restructuring loan terms. *See* Memorandum from Joseph E. Stiglitz, *supra* note 177. However, in order to adequately compensate for negative equity, especially for homeowners who are hundreds of thousands of dollars underwater, interest rates would have to be truly low—somewhere around 2–3%.

212. *See, e.g.*, Rebel A. Cole, The Housing-Asset Relief Program: A Plan for Stabilizing the Housing and Securities Markets (Apr. 22, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1338883 (proposing that "$300 billion in TARP or stimulus funds" be "used to write down the principals on [underwater] mortgages").

213. *See generally, e.g.*, Chris Foote et al., *A Proposal To Help Distressed Homeowners: A Government Payment-Sharing Plan* (Fed. Reserve Bank of Bos., Paper No. 09-1, 2009), *available at* http://ssrn.com/abstract=1432514 (proposing a "government payment-sharing arrangement" under which the government would pay part of the homeowner's existing mortgage, providing a "significant reduction in the homeowner's monthly mortgage payment").

214. *See* Adam Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 565 (arguing for modification of home-mortgage debt in bankruptcy proceedings); *cf.* Eric A. Posner & Luigi Zingales, *The Housing Crisis and Bankruptcy Reform: The Prepackaged Chapter 13 Approach* 8–9 (Chi. Booth Sch. of Bus. Research Paper Series, Working Paper No. 09-11; Univ. of Chi., Olin Law & Econ. Program Research Paper Series, Working Paper No. 459, 2009), *available at* http://ssrn.com/abstract=1349364 (discussing a similar proposal from Senator Richard Durbin).

215. 11 U.S.C. § 1322(b)(2) (2006).

could show that they could not "afford" their mortgage payments. It would thus fail to assist many responsible underwater homeowners who did not reach beyond their means, but simply purchased at the wrong time.

Partially in response to this concern, Eric Posner and Luigi Zingales have suggested changing federal bankruptcy law to allow "prepackaged," or streamlined, mortgage cramdowns under Chapter 13 of the Bankruptcy Code.[216] Under Posner and Zingales's intriguing proposal, any homeowner who lives in a zip code where the median home price has dropped by more than 20% from its peak would have the right to submit a "Chapter 13 prepack."[217] This prepack "would simply contain a new mortgage amount that is equal to the old mortgage amount discounted by the percentage decline of the median house price for the zip code. Monthly payments would decline by the same percentage; the term of the mortgage would not be changed."[218] The creditor would not have the right to oppose the prepack,[219] but would be entitled to a percentage of the home's appreciation upon sale—a percentage equal to the percentage reduction in the principal pursuant to the prepack.[220]

Like the Levitin proposal, the prepackage bankruptcy would be a positive step in circumventing the barriers to renegotiation caused by norm asymmetry. The prepack also has several advantages when compared to the Levitin proposal, including that it would impose less of a burden on the courts because the prepackage bankruptcy would be "automated, requiring only a rubber stamp by a bankruptcy judge."[221] Nevertheless, the prepack proposal has significant drawbacks as well, including that it would intrude ex post into the contractual relationship of private parties and would create additional administrative burdens for already overburdened bankruptcy courts. It is also a blunt instrument in that it arbitrarily limits cramdowns to zip codes where prices have declined 20% and does not account for the often great variation of depreciation within a single zip code.[222]

While both the Posner and Zingales proposal and the Levitin proposal are worth considering, understanding norm asymmetry suggests other possibilities. One solution that naturally follows, for example, would be for the government—or more likely some

216. *See generally* Posner & Zingales, *supra* note 214.
217. *Id.* at 21.
218. *Id.*
219. *Id.* at 21–22.
220. *Id.* at 22.
221. *Id.* at 1.
222. *Id.* at 20. The plan would thus be both overinclusive and underinclusive, allowing some owners a write-down even when their particular neighborhood had not experienced declines exceeding the magical 20% cutoff, but denying relief to others whose neighborhoods had experienced steep declines, but whose overall zip code had fared better than a 20% decline.

consumer-advocacy group—to begin a public education campaign encouraging underwater homeowners to walk if their lenders are unwilling to negotiate. At a minimum, federally approved and supported housing- and credit-counseling agencies should cease sending the fear-laden message that foreclosure should be avoided at all costs.[223] They should also provide accurate information about the likelihood of deficiency judgments,[224] extent of tax liabilities,[225] and recovery time for credit scores.[226] In other words, the government should at least stop perpetuating scary myths about the consequences of foreclosure and tone down its moral rhetoric.

Given the credit-rating system's role in enforcing norm asymmetry, however, additional steps might be necessary to level the playing field between borrowers and lenders and to empower homeowners to renegotiate underwater mortgages. Stated differently, some steps should be taken to curb lenders' ability to hold borrowers' credit scores as substitute collateral for the loan. To explain, in the case of an underwater mortgage, the portion of the mortgage above the home's present value effectively becomes unsecured debt. Lenders compensate for this by holding the underwater homeowner's credit score as the new collateral, and threaten to ruin it in response to the borrower's exercise of the contractual default option.[227] Not only does this alter the underlying agreement that the home alone serves as collateral, but also, because many underwater homeowners highly value their credit scores,[228] this frequently allows lenders to use the "credit threat" to reap the benefit, but escape the costs, of their bargain.[229] Borrowers, of course, lack any similar leverage over lenders.

One solution to remedy this imbalance would be to amend the FCRA to prevent lenders from reporting mortgage defaults and

223. *See supra* notes 149–50 and accompanying text.
224. *See supra* note 152 and accompanying text.
225. *See supra* note 55 and accompanying text.
226. *See supra* note 50 and accompanying text.
227. *See supra* notes 167–69 and accompanying text.
228. *See supra* notes 159–66 and accompanying text.
229. *See supra* notes 167–69 and accompanying text. The contractual option to default, also known as the "put option," should be particularly robust in antideficiency judgment states, such as Arizona and California, where borrowers pay on average an extra $800 in closing costs per $100,000 borrowed for the option to default without lender recourse beyond taking possession of the collateral itself. *See* SUSAN E. WOODWARD, A STUDY OF CLOSING COSTS FOR FHA MORTGAGES 51–52 (2008), *available at* http://www.huduser.org/Publications/pdf/FHA_closing_cost.pdf. Even in a recourse state, however, the borrower has the implied option to default and leave the lender to pursue whatever legal remedies may be available, including foreclosure and a deficiency judgment. Because these legal remedies are generally unattractive to lenders, they prefer to use extrajudicial measures such as threatening a borrower's credit score to induce them to forego the exercise of the default option. *See supra* notes 196–99 and accompanying text.

foreclosures to credit-rating agencies.[230] While this proposal is not the only possible solution, eliminating the credit threat may in fact be the key to eliminating norm asymmetry between lenders and borrowers, thereby forcing a more equitable division of the financial burden of the housing-market collapse. It might also help prevent the foreclosure crisis from spreading.

As a practical matter, preventing lenders from reporting mortgage defaults to credit-rating agencies would eliminate lenders' ability to collateralize the borrower's credit score and threaten it in retaliation for the borrower's exercise of the "put option."[231] It would thus help considerably in leveling the playing field between lenders and borrowers. With the threat of damage to the borrower's credit score removed, the borrower could more credibly threaten to walk away absent a principal reduction. It bears emphasizing, however, that the borrower would be unlikely to bargain "ruthlessly" because, even without the credit reputation hit, there are significant transaction costs to moving and finding a new home.[232] Indeed, because of these costs and attachment to one's home,[233] few homeowners would walk at less than 10% negative equity.[234]

Thus, if a mortgage was underwater, for example, by 20%, the lender and homeowner might agree to share equally in absorbing the loss, or a homeowner might agree to absorb all of the negative equity in exchange for a reduction in the interest rate. The parties might also agree to condition any reduction in principal on the lender sharing in future appreciation—in effect converting the mortgage into a shared equity loan. In other words, the lender and homeowner would be free to negotiate a mutually beneficial

230. Ideally, this change would be coupled with an extension beyond the year 2012 of the federal tax waiver on "forgiven" portions of one's mortgage, and a national antideficiency statute barring lenders from pursuing homeowners for a mortgage's unsatisfied portion upon foreclosure. Though not without controversy, extending the tax waiver and passing an antideficiency statute would address the underlying economic costs of default to the borrower and, other consequences aside, it should therefore be self-explanatory why these measures would help improve borrowers' bargaining position.

231. Such a change would also serve as an important signal from the government, sending the message that a borrower who exercises a contractual right to default should not be viewed as immoral or irresponsible.

232. *See* Avery et al., *supra* note 118, at 622.

233. Indeed, lenders benefit not only from borrowers' negative emotions such as guilt and fear, but also from borrowers' positive attachment to the idea of homeownership. This emotional attachment to homeownership is socially cultivated and has been internalized by most Americans, who generally see homeownership as both a good investment and an integral part of the American Dream and thus may cling to their homes when they could walk away, rent something nicer, and put the money they save into an investment with better returns. *See Talk of the Nation: Re-thinking American Dream of Home Ownership* (NPR radio broadcast Dec. 15, 2009), *available at* http://www.npr.org/templates/story/story.php ?storyId=121472986.

234. Guiso, Sapienza & Zingales, *supra* note 16, at 21.

arrangement to continue the mortgagor-mortgagee relationship, or to settle for the benefit of their original bargain and allow mortgagor to have the house.

Additionally, this approach would have significant advantages over Posner and Zingales's proposal for forced cramdowns. First, it would allow the parties to come to their own mutually agreeable solution to the negative equity problem, without the government intruding into a private contractual relationship and rewriting the contract. Second, it would allow for nuanced, borrower-specific solutions, rather than across-the-board treatment for whole zip codes, or arbitrary cut-offs based on a set percentage of the borrower's gross monthly income. Third, it would not require the government to create a new bureaucratic structure or expend any taxpayer money, nor would it impose new regulations on lenders. The proposal simply identifies a distortion in the market created by norm asymmetry and eliminates that distortion. Indeed, the proposal to eliminate the credit threat is, at heart, a market-based solution. It should thus be preferable to a government bailout of homeowners or a government takeover of the lending industry.[235] By the same token, it should be attractive to consumer advocates, as it protects the credit of underwater homeowners and gives them more leverage to negotiate.[236]

Nevertheless, some might still object that eliminating the credit threat would encourage default among underwater homeowners.[237]

235. The proposal is, of course, not likely to satisfy those who believe homeowners have a moral obligation to pay their mortgage regardless of whether it would be more efficient to breach. Nor, it goes without saying, is the proposal going to be welcomed by the lending industry.

236. There is already a large and growing industry devoted to helping underwater homeowners negotiate write-downs with lenders. As evidence of the size of this industry, there have been "massive numbers of complaints" in California against lawyers who have taken fees to renegotiate mortgages and have failed to deliver. *See* Jim Wasserman, *Loan Modification Firms Banned from Demanding Upfront Fees*, SACRAMENTO BEE, Oct. 13, 2009, http://www.sacbee.com/2009/10/13/2249150/loan-modification-firms -banned.html. As a result, lawmakers in California passed legislation to bar up-front fees for mortgage renegotiation services. *See* S. 94, 2009 Leg., Reg. Sess. (Cal. 2009). It thus seems fair to say that eliminating the credit threat would at a minimum help the thousands of people who are already trying to negotiate with their lenders but finding they have little leverage unless they are willing to signal their willingness to walk by missing payments and sacrificing their credit scores.

237. Rather than objecting that eliminating the credit threat would encourage default among underwater homeowners, others are likely to argue the opposite—namely, that eliminating the credit threat would do nothing to alter homeowner behavior. This objection would be grounded on surveys that have shown that many people don't understand what a credit score is, much less care about their own. *See* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 30 (2008) ("Survey evidence also suggests that '[m]ost consumers do not understand what credit scores measure, what good and bad scores are, and how scores can be improved.'" (quoting Press

But that is, in part, the point: in an environment in which there was less stigma attached to default and homeowners could more credibly threaten to walk away, lenders would be more willing to negotiate with underwater homeowners. The end result would paradoxically be fewer defaults, as homeowners would not feel compelled—or be told—to default before the lender would negotiate. Moreover, even if there were more initial defaults, fewer of these defaults would end in foreclosures, as a missed payment would signal the homeowner's seriousness to the lender and bring the lender more quickly to the bargaining table. This would stand in sharp contrast to the current environment in which lenders often have an economic incentive not to work with borrowers, on the theory that the vast majority of those who threaten to default will not follow through and that modifying mortgages of underwater homeowners will simply encourage more

Release, Consumer Fed'n of Am. & Providian, Most Consumers Do Not Understand Credit Scores According to a New Comprehensive Survey (2004) [hereinafter Credit Score Press Release], *available at* http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/092104 creditscores.PDF)). However, credit knowledge surveys have not assessed the subset of people with high credit scores to see what they know or how they feel about credit scores (and, as discussed above, 94% of people with prime loans have high credit scores). *See supra* note 158 and accompanying text. The subset of the population with high credit scores likely cares more and knows more about credit scores than does the general population. Moreover, despite headlines to the contrary, credit-knowledge surveys have actually shown that a very significant portion of the population does in fact understand the importance of good credit, cares about their credit scores, and understands the basics of credit reporting. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, CREDIT REPORTING LITERACY: CONSUMERS UNDERSTOOD THE BASICS BUT COULD BENEFIT FROM TARGETED EDUCATIONAL EFFORTS 11 (2005), *available at* http://www.gao.gov/new.items/d05223.pdf (reporting that 70% of respondents correctly defined a credit score); Credit Score Press Release, *supra* (concluding that most consumers do not understand credit scores despite finding that "most customers surveyed correctly understand that lenders use credit scores," 34% correctly understand that credit scores measure credit risk as opposed to ability to pay, and 60% correctly understand how to improve their credit score); *Poll: Consumers Don't Understand Credit Reporting, Favor Reforms*, INS. J. (Aug. 11, 2003), http://www.insurancejournal.com/news/national/2003/08/11/31410.htm (finding that consumers don't understand many specifics of credit reporting but that 97% understand that they have the right to see their credit report, 81% know that consumers who fail to qualify for a loan have the right to a free credit report, 46% understand that in most states they must pay a fee to obtain their credit report, 45% understand that their credit score may be lowered if they use all of the credit available on their credit card, and 73% understand that their credit score measures their credit-worthiness). Individuals who care about and understand their credit score likely constitute a much more significant portion of people with prime loans (which is only one subset of individuals about which this proposal is concerned) than of the general population. Moreover, one does not really need to understand much about one's credit score to not want to mess it up—and even the most ignorant homeowner likely knows a foreclosure will hurt his credit. It thus makes sense that removing the credit threat would alter the behavior of at least a significant minority of underwater homeowners.

defaults.[238]

The proposal's value in forcing lenders to negotiate should not be underestimated. Indeed, "[s]everal major policy actions to date have involved encouraging lenders, in one way or another, to renegotiate loan terms in order to reduce borrower debt loads."[239] This includes, of course, the Making Home Affordable program, which tries to encourage renegotiation by offering modest financial incentives to lenders.[240] As the paucity of loan modifications under this program evidences,[241] however, offering lenders a few thousand dollars to modify delinquent loans does not alter the underlying economic incentives or the lender-borrower dynamic that drives lenders to prefer foreclosure to renegotiation.[242] Voluntary renegotiation of home mortgages has remained the elusive "public policy holy grail."[243] This failure to effectively encourage voluntary renegotiation has stemmed, at least in part, from policy makers' failure to appreciate the role of norm asymmetry in lenders' unwillingness to negotiate with borrowers (at least until borrowers have shown their willingness to sacrifice their credit scores). Eliminating the credit threat may thus, in fact, be part of the key to unlocking the holy grail of voluntary renegotiation.

Despite these benefits, one might still object to the proposal on the theory that the lender's ability to collateralize borrowers' credit scores reduces risk to the lender, thereby allowing them to offer lower interest rates.[244] Thus, the argument would go, eliminating

238. Even a relatively modest increase in the number of credible threats of default could alter the economic calculation for lenders that currently causes them not to renegotiate. Such would be the likely outcome of removing the credit threat, as the signaling function of a late payment would be less costly to borrowers, meaning that many more people would default if necessary in order to bring lenders to the table. But it should be emphasized that the increase in defaults would likely be temporary, as lenders would soon comprehend that it would be less costly to negotiate with borrowers who threaten default before they actually stop making payment.

239. Adelino, Gerardi & Willen, *supra* note 190, at 1.

240. *See* Making Home Affordable Memo, *supra* note 204.

241. Though the Treasury Department predicted that this programs would offer assistance to seven to nine million homeowners, *id.*, only 360,165 loan modifications had taken place under the program as of August 2009. MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH AUGUST 2009 (2009), http://www.financialstability.gov/docs/MHA-Public_090909.pdf.

242. *See* Adelino, Gerardi & Willen, *supra* note 190, at 1 ("[L]ess than 2 percent of the seriously delinquent borrowers received a concessionary modification in the year following their first serious delinquency . . . [whereas] foreclosure proceedings were initiated on approximately half of the loans . . . .").

243. *See id.* at 1, 17 ("[T]here is a consensus among many observers that concessionary modifications are the most, or possibly the only, effective way of preventing foreclosures.").

244. Relatedly, others might argue that barring the reporting of mortgage defaults would reduce the utility of the credit-reporting system in providing information about the reliability of potential borrowers. This is true only if one assumes that the same information about borrowers is relevant for secured

the credit threat would increase borrowers' lending costs and restrict credit. At the outset, it bears noting that this is the typical argument against most consumer protections[245] and that similar arguments can be expected against *any* proposal that would effectively shift some of the burden of underwater mortgages off homeowners and onto lenders.[246] Indeed, the same arguments about increased interest rates and restricted credit have been made in opposition to mortgage cramdowns[247]—though recent empirical work by Adam Levitin and Joshua Goodman has suggested that permitting bankruptcy modification of mortgages would have little to no impact on mortgage markets.[248] Predictions of high interest rates and restricted credit should thus be approached with a healthy bit of skepticism.

Moreover, any possible costs of eliminating the credit threat

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versus unsecured debt. However, it would seem that secured debt, such as home mortgages, should operate in a different sphere than unsecured debt, when in fact the only collateral the lender has is the borrowers' credit score. *See* Avery et al, *supra* note 118, at 625 (discussing the separate risk-assessment model that already exists for home mortgages).

245. *See* Posner & Zingales, *supra* note 214, at 19 ("The financial industry opposes any loan modification because it will increase the future cost of credit and reduce its availability.").

246. *See id.*

247. *See, e.g.*, Donald C. Lampe, Fred H. Miller & Alvin C. Harrell, *Introduction to the 2008 Annual Survey of Consumer Financial Services Law*, 63 BUS. LAW. 561, 568 (2008) ("Solutions designed to prevent future problems by reducing the availability of credit to marginal borrowers may (in addition to affecting adversely those future borrowers) worsen the current plight of existing marginal borrowers who need to refinance their homes. Direct relief for troubled borrowers, e.g., a foreclosure moratorium or expanded bankruptcy relief, may have the same effect. To some extent this has already happened. The tightening of mortgage law requirements and regulatory restrictions over the past few years in response to allegations of predatory lending have probably contributed to the dramatic increase in foreclosures by making it more difficult for troubled borrowers to refinance. A significant further tightening of these restraints—we have heard this further tightening referred to as 'more robust regulation'—may worsen the problem and increase the number of consumers facing foreclosure as a result." (footnotes omitted)).

248. *See* Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* (Bus., Econ. & Regulatory Policy Working Paper Series, Paper No. 1087816; Pub. Law & Legal Theory Working Paper Series, Paper No. 1087816, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087816 (arguing that current and historical data suggests that permitting bankruptcy modification of mortgages would have no or little impact on mortgage markets, including mortgage interest rates); *see also* Levitin, *supra* note 214, at 565 (arguing that "permitting modification would have little or no impact on mortgage credit cost or availability"); Adam Levitin, *A Critique of the American Bankers Association's Study of Credit Card Regulation* (Bus., Econ. & Regulatory Policy Working Paper Series, Paper No. 1104327; Pub. Law & Legal Theory Working Paper Series, Paper No. 1104327, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1029191& (disputing contention by American Bankers Association that credit-card regulation increases interest rates).

should be weighed against the potentially enormous benefit of empowering homeowners to more successfully negotiate away their negative equity. First, numerous studies have shown that negative home equity reduces consumer spending: the higher the incidence of negative equity in the housing market, the weaker aggregate demand in the overall economy.[249] Second, negative home equity is associated with drastically reduced household mobility,[250] which has a range of negative macroeconomic effects, including increased structural unemployment, reduced productivity, and limited supply capacity.[251] Empowering homeowners to reduce their negative equity through renegotiation could thus have enormous economic benefits in its own right.

Moreover, barring the reporting of mortgage defaults could have positive effects on future lender behavior. This is because in the case of a home mortgage, the lender has the ability to ensure that the collateral is sufficient to create the proper economic incentives for borrowers not to default. In other words, they need not rely on credit scores to control their risk, but can instead ensure that the

249. *See, e.g.*, DEUTSCHE BANK, *supra* note 10, at 16 (noting that negative equity suppresses middle-class consumption); Andrew Benito et al., *House Prices and Consumer Spending,* 46 Q. BULL. 142 (2006) (Eng.) (showing that negative equity in part negatively affects aggregate consumer spending); Matthew Corder & Nyssa Roberts, *Understanding Dwellings Investment*, 48 Q. BULL. 393 (2008) (Eng.) (indicating that negative equity reduces the incentive for homebuilders and homeowners to invest in housing); Tomas Hellebrandt, Sandhya Kawar & Matt Waldron, *The Economics and Estimation of Negative Equity*, 49 Q. BULL. 110, 111 (2009) (Eng.) ("A rising incidence of negative equity is often associated with weak aggregate demand."); Andrew Benito & Haroon Mumtaz, *Consumption Excess Sensitivity, Liquidity Constraints and the Collateral Role of Housing* (Bank of Eng., Working Paper No. 306, 2008) (noting that negative equity raises the probability of a household being credit constrained and thus unable to purchase); Richard Disney, Andrew Henley & David Jevons, House Price Shocks, Negative Equity and Household Consumption in the UK in the 1990s (Jan. 11, 2002) (unpublished manuscript), *available at* http://repec.org/res2002/Disney.pdf (finding that negative equity leads to greater savings and lower spending).

250. *See* Hellebrandt, Kawar & Waldron, *supra* note 249, at 112 ("Negative equity can affect household mobility by discouraging or restricting households from moving house."); Andrew Henley, *Residential Mobility, Housing Equity and the Labour Market*, 108 ECON. J. 414, 426 (1998) (Eng.) (finding that twice as many individuals would have moved in the early 1990s in England had they not had negative equity); Fernando V. Ferreira, Joseph Gyourko & Joseph Tracy, *Housing Busts and Household Mobility* (Nat'l Bureau of Econ. Research, Working Paper No. W14310, 2008), *available at* http://www.nber.org /papers/w14310.pdf (discussing the correlation between decreased household mobility and negative equity); *see also* Louis Uchitelle, *Unsold Homes Tie Down Would-Be Transplants,* N.Y. TIMES, Apr. 3, 2008, at A1 ("The rapid decline in housing prices is distorting the normal workings of the American labor market. Mobility opens up job opportunities, allowing workers to go where they are most needed.").

251. *See* Hellebrandt, Kawar & Waldron, *supra* note 249; Henley, *supra* note 250, at 422.

purchase price of the financed home is in line with historically sustainable price-to-rent ratios, demand sufficient down payment, and eschew interest-only and negative-amortization loans.[252] Lenders would be more inclined to take these sensible precautions if borrowers were empowered to behave according to the same market norms as lenders and breach when it is efficient to do so. This added caution by lenders might in turn help to avoid a repeat of the current housing crisis.

The above proposal should not, however, obscure the broader point: norm asymmetry between borrowers and lenders creates disincentives for lenders to renegotiate underwater mortgages and makes it unlikely that lenders will work with borrowers to address the negative equity issue. Any proposal to address the problems created by negative equity must account for this reality, either by addressing the resulting distributional inequities or by changing the rules of the game. Viable approaches could include: (1) cutting lenders out of the picture altogether through government financing of mortgages at low interest rates; (2) using stimulus funds to buy down the mortgages of underwater homeowners;[253] (3) forcing lenders to reduce mortgage balances by court order; or (4) leveling the playing field by eliminating the ability of lenders to trash a borrower's credit score in retaliation for the borrower's exercise of his contractual right to default.[254]

Regardless of the precise policy prescription, it is time to put to rest the assumption that a borrower who exercises the option to default is somehow immoral or irresponsible. To the contrary, walking away may be the most financially responsible choice if it allows one to meet one's unsecured credit obligations or provide for the future economic stability of one's family. Individuals should not be artificially discouraged on the basis of "morality" from making financially prudent decisions, particularly when the party on the other side is amorally operating according to market norms and could have acted to protect itself by following prudent underwriting practices. The current housing bust should be viewed for what it is: a market failure and a failure to regulate, not a moral failure on the part of American homeowners. That being the case, it is time to take morals out of the picture and search for an equitable solution to the negative equity problem.

252. Moreover, to the extent that a mortgage default is relevant to a credit application, lenders could ask and borrowers could be required to disclose that information—as borrowers are now required to do even when the default is no longer reflected in their credit score.

253. *See* Cole, *supra* note 212 (proposing that "$300 billion in TARP or stimulus funds" be "used to write down the principals on underwater mortgages").

254. This limit on credit reporting should also, as discussed above, be combined with a national antideficiency statute and an extension of the tax waiver for forgiven mortgage debt.