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## Homes Underwater: A Stumbling Block for Recovery

**One in Four Mortgages Will Outpace Home Values by 2011**

By [Martha C. White](#) 9/1/09 6:00 AM



Image by: Matt Mahurin

Despite the recent good news that U.S. home prices rose 2.9 percent in the second quarter of 2009, it's too early to call a turnaround for the battered housing sector. Although this modest increase in the S&P/Case-Shiller national home index is the first uptick since 2006, the number of homes worth less than their mortgages has ballooned. This undertow of debt threatens homeowner stability now, and has ramifications for a long-term economic recovery.

Two new studies reveal that the rate of “underwater” mortgages — that is, where the mortgage debt outweighs the current value of the house — is higher than previously believed, and point to further increases in the coming months.



Illustration by: Matt Mahurin

According to real estate data firm Zillow, 23 percent of all single-family homes are saddled with mortgages worth more than the present value. Moody's Economy.com offers a similar number; according to that company's research, 24 percent of all homes have underwater mortgages, up from 15 percent a year ago. Additionally, another 8 percent of homeowners, while not technically underwater, have mortgage amounts that cancel out their equity.

This adds up to some 16 million homes, according to Celia Chen, senior director at Moody's Economy.com. "Home prices have increased in the last month or two but I think it's too early to call an end to the downturn," she said.

That not-terribly-optimistic assessment might turn out to be an understatement. Investment bank Deutsche Bank released a report earlier this month saying that 48 percent — nearly half — of all home mortgages in the country will be upside-down by early 2011. According to Deutsche Bank managing director and global head of securitization research Karen Weaver, the historical rate of mortgage defaults has been about 7 percent. "However, that experience is of limited relevance because it's from a period of much more moderate home price declines and stricter lending standards," she cautioned in an emailed response to questions. In today's economy, it's more realistic to expect up to 20 percent of borrowers to default.

"This is a slow-motion second shoe to drop on the economy," said Christopher B. Leinberger, a visiting fellow at the Brookings Institution. "My concern is that it could be the catalyst for a W, or double-dip, recession. Sure, there are some green shoots but there are also these economic depressants that have to be dealt with."

New research out of Northwestern University shows that even some homeowners who can afford to make their mortgage payments choose instead to default when their homes plummet in value relative to their mortgages. The study, which surveyed homeowners across the country last December and again in March, found that 26 percent of all defaults are what researchers termed "strategic." Essentially, this means the homeowner actually has the money to pay his or her mortgage and deliberately decides not to. In parts of the country where home prices have lost a significant percentage of their value, these borrowers decide it's worth the hit on their credit score to walk away from homes that might never again be worth what they paid for them.

According to Northwestern professor Paola Sapienza, one of the authors of the study, even homeowners who said in a survey that they have a moral objection to walking away from a debt change their mind if the ratio of their negative equity balloons. According to her research, when homeowners' negative equity hits 50 percent — a not uncommon number in certain communities — 17 percent of homeowners will default, even if they can afford their mortgage payments. Since lenders very rarely sue homeowners for defaulting, the consequences for defaulting are generally limited to a battered credit score for a period of years. The danger is that, since each foreclosure drags down the values of surrounding homes, the number of borrowers handing the keys over to their lender could snowball as homeowners watch their neighbors default.

Worse, negative equity creates a ripple effect that extends beyond the affected homeowners. Even among those not trying to sell their homes or in imminent danger of foreclosure, the lack of a financial cushion in the form of home equity puts a damper on consumer spending. “A lot of people were feeling good about their wealth position,” says Economy.com’s Chen. Now that there is no equity, it’s having a negative impact on consumer spending.” Lower consumer spending leads to decreased retail sales, manufacturing slowdowns and, ultimately, job losses or reduced income. This, in turn, can prompt a new round of mortgage defaults, starting the cycle all over again.

This hurts lenders as well as homeowners. Despite the injection of government capital into banks, financial institutions — especially smaller regional or community banks — aren’t out of the woods yet. The TARP Congressional Oversight Panel said in its August report that banks are likely to need billions more in government support. Even with this aggressive intervention, some banks will still fail. Small and medium-sized community banks, especially those centered in areas that have been hard-hit by the real estate downturn, are the most likely victims. “It’s obviously a negative for banks,” said Economy.com’s Celia Chen. “I expect there will be more banks that go under.” Future bank failures will tax the already-strained FDIC. The agency’s most recent quarterly report revealed that its reserve, which it uses to pay depositors when banks fail, is down to \$10.4 billion. Last year, the FDIC’s reserve was \$45.2 billion.

Even when the economy strengthens and employment increases, negative equity makes it prohibitive, if not impossible, for homeowners to sell their homes. This will hamper an eventual jobs recovery if workers can’t move to where employers need them to be. “It has cause a significant issue in the relocation industry. People are reluctant to move,” said Joe Benevides, chair of Worldwide ERC, a workforce mobility association. “Employers are finding that their first choice candidate is not able to take relocation for financial reasons.” The time frame for relocating an employee, which includes the time needed to sell the worker’s current home, purchase a new one and complete a move had jumped. The process, which used to take between 120 and 180 days, now stretches from 180 days to as much as a year.

There’s no single solution to the problem of burgeoning negative equity, but industry analysts and policy experts say both short- and long-term fixes are necessary. Mortgage loan modifications are still discussed, although existing programs have barely put a dent in the foreclosure crisis. Some critics say this is because modifications so far have targeted interest rates rather than principal balances. Modifications that target principals are a double-edged sword, though; Casey Mulligan, a professor at the University of Chicago’s Booth School of

Business, points out that homeowners may be incentivized to stop making payments on their mortgages if they think the threat of foreclosure will force the lender to cut them a deal. Mulligan suggests a simple solution would be to modify all underwater mortgages, although he concedes that this solution probably wouldn't pass muster with already-beleaguered lenders.

Christopher Leinberger of the Brookings Institution believes some relief could come from public-transit investment. Since many of the most-troubled properties lie in far-flung exurbs of major urban centers, expanded public transit that makes it cheaper and more convenient for people to get to work in the distant city will increase property values. Leinberger says smart urban planning done around these transit hubs will also have a positive effect; in regions where tracts of single-family homes have been replaced by a mix of high-density residential units (such as apartment buildings) and retail space, property values go up and local tax rolls are bolstered by the presence of commercial property.

A major antidote will be the passage of time; many borrowers experiencing low to moderate negative equity will see investment in their homes pay off eventually. Unfortunately, there's no way to create a fast-acting fix that mimics this effect. "For the most part, we have to let it happen. We needed a correction," said Deutsche Bank's Karen Weaver. "And, as we let the crisis play out, shore up the rest of the economy with low rates and government stimulus."