

## Case 1.2: Just Drop off the Key, Lee

Hindsight, they say, is 20/20. So, in retrospect, it is not so surprising that the boom in real estate prices of just a few years ago was followed by a painful collapse. Encouraged by low interest rates and a willingness of banks to lend money to almost anybody, many people had jumped into the housing market, sometimes buying expensive homes with mortgages they could barely afford, based on the belief, celebrated in television shows like “Flip This House,” that housing prices would continue to go up and up and up. But the law of gravity applies to housing prices, too, it seems. Inevitably, the housing market cooled down, and housing prices stopped rising; then they slowly reversed direction and began steadily declining. As a result, many people found themselves making mortgage payments on homes worth far less than what they had originally paid for them. Moreover, many of them had been talked into taking mortgages they didn’t really understand, for example, mortgages with adjustable rates or with special “balloon” payments due after a few years, or that were too expensive for them to afford in the first place. The financial crisis of 2008 and the recession that followed only made things worse. Faced with monthly payments they could no longer sustain, these borrowers lost their homes through foreclosure. Widespread foreclosures, in turn, drove housing prices even lower, leaving more and more homeowners—by 2010 an estimated 5.4 million of them—“under water,” that is, with mortgage balances at least 20 percent higher than the value of their homes.

Consider thirty-year-old software engineer, Derek Figg. He paid \$340,000 for a home in the Phoenix suburbs. Two years later, its value had dropped to less than \$230,000, but he still owed the bank \$318,000. As a result, Figg decided to stop paying his mortgage, defaulted on his loan, and walked away from his home. Or consider Benjamin Koellmann. He paid \$215,000 for an apartment in Miami Beach, which three years later was worth only \$90,000. Although still paying his mortgage, he is thinking about following Figg’s example.

What distinguishes Figg and Koellmann from many other homeowners whose homes are under water or who are in mortgage trouble is that both have good jobs and could afford to keep making their monthly payments—if they chose to. Moreover, they are smart guys and knew what they were doing, or thought they did, when they bought their homes. However, figuring that it would take years for their properties to regain their original value and that renting would be cheaper, they are among a growing number of homeowners who have either walked away from their mortgages or are considering it, not out of necessity, but because doing so is in their financial interest. Experts call this “strategic default.” Or, in the words of an old Paul Simon song, “Just drop off the key, Lee, and get yourself free.”

As any financial advisor will tell you, there are lots of good reasons not to default on a mortgage. A foreclosure ruins a consumer’s credit record for seven years, and with a low credit score, one must pay a higher interest rate on auto and other loans. Moreover, some states allow lenders to seize bank deposits and other assets of people who default on mortgages. Benjamin Koellmann also worries that skipping out on his mortgage might hurt

him with a future employer or diminish his chance of being admitted to graduate school. Still, there's no denying that for some borrowers simply mailing in the keys and walking away can make sense. But that leaves one question unanswered: Do they have a moral responsibility to meet their financial commitments?

The standard mortgage-loan document that a borrower signs says, "I promise to pay" the borrowed amount. A promise is a promise, many people believe; they think you should keep making your mortgage payments even if doing so is inconvenient. In fact, 81 percent of Americans agree that it is immoral not to pay your mortgage when you can. George Brenkert, professor of business ethics at Georgetown University, is one of them. He maintains that if you were not deceived by the lender about the nature of the loan, then you have a duty to keep paying. If everybody walked away from such commitments, he reasons, the result would be disastrous. As Paola Sapienza, a finance professor at Northwestern University, points out, each strategic default emboldens others to take the same step, which he describes as a "cascade effect" with potentially damaging consequences for the whole economy. Economist David Rosenberg adds that these borrowers were not victims. They "signed contracts, and as adults should be held accountable."

Others disagree. Brent White, a law professor at the University of Arizona, says that homeowners should base the decision whether to keep paying or walk away entirely on their own interests "unclouded by unnecessary guilt or shame." They should take their lead from the lenders, who, he says, "ruthlessly seek to maximize profits or minimize loss irrespective of concerns of morality or social responsibility." People who think like Professor White also argue that the banks fueled the housing boom in the first place by loaning money, based on unrealistic appraisals of home values, to people who were unlikely to be able to keep up their payments in order to resell those loans to other investors. Others suspect a double standard. Homeowners are criticized for defaulting but businesses often declare bankruptcy even when they have money in the bank and could keep paying their bills. In fact, doing so is often thought to be a smart move because it trims their debt load and allows them to break their union contracts.

Benjamin Koellmann, for his part, remains conflicted. "People like me are beginning to feel like suckers. Why not let it go in default and rent a better place for less? ... There is no financial sense in staying." Still, he struggles with the ethical side of the question: "I took a loan on an asset that I didn't see as overvalued," he says. "As much as I would like my bank to pay for that mistake, why should it?" John Gourson, chief executive of the Mortgage Bankers Association, concurs with this. In addition, he says, defaulting on your mortgage and letting your home go into foreclosure hurts the whole neighborhood by lowering property values. He adds: "What about the message they still send to their family and their kids and their friends?"

For his part, Derek Figg admits that defaulting was the "toughest decision I ever made." Still, he faced a "claustrophobic situation," he says, because if ever he lost or quit his job, he would have been unable to sell his house and move somewhere else. Moreover, he says, lenders

“manipulated” the housing market during the boom by accepting dubious appraisals. “When I weighed everything,” he says, “I was able to sleep at night.”

Percentages	Date								
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Below 1%	X								
From 1% to 2%		X	X						
From 2% to 3%									X
From 3% to 4%				X			X	X	
From 4% to 5%					X	X			



U.S. foreclosure rates in recent years, in percentages

### Discussion Questions

1. What would you do if you were in Figg’s or Koellmann’s situation? What factors would you consider?
2. Do people have a moral obligation to repay money that they borrow, as Professor Brenkert thinks, or is this simply a business decision based on self-interest alone, as Professor White thinks?
3. “It is morally permissible for homeowners whose homes are under water to default on their mortgages even if they could continue to pay them.” What arguments do you see in favor of this proposition? What arguments do you see against it?
4. When it comes to paying your debts, does it matter whether you borrow money from a bank or from an individual person? Explain why or why not.
5. Suppose your moral principles imply that you should keep on paying your mortgage, but financial self-interest counsels you to walk away. How are you to decide what to do?
6. Repaying a loan is a legal obligation. Is it also a moral obligation? Explain why or why not.
7. Are the banks responsible for the housing boom that enticed people to buy homes at inflated prices? If so, does this affect whether you have an obligation to repay your loan? What about Professor White’s contention that the banks themselves care only about maximizing profit?

