Ruthless, or Just Rational? - Part II

Posted on **August 11, 2010** by Linda R. Stahl

Linda Stahl is back with the follow-up to her discussion on strategic defaults.

Last time I raised the question of why voluntary defaults by homeowners have been such big news lately. I suggested that homeowners may breach more frequently than is best for society because nonrecourse debt spares homeowners the full cost of breach.

Let's assume that it is a societal good for the price paid for property to equate with its value. And let's also assume that in the run up to the financial meltdown, this equation was out of balance. To bring price and value in alignment, homeowners seem to be following this calculus:

If **[cost of alternative housing + cost of breach] < [mortgage balance],** ***then*** **DEFAULT**

Otherwise, they keep making those payments.

But where debt is nonrecourse, or where the chance of a lender pursuing a deficiency judgment is slim-to-none, you might think the cost of breach is artificially low and will occur too frequently.

Some numbers illustrate the point. Assume that my home is worth $75,000, and that my mortgage balance is $100,000. If I can be free and clear of the mortgage debt after foreclosure, I should default if I can find alternative housing for less than $100,000. If, however, I must fully compensate the lender for the breach, then I will still owe $25,000 after foreclosure, and should only default if I can find a suitable home for $75,000 or less.

So does this mean public policy should favor enforcement of full-recourse mortgages?

Probably not.

In the usual case, both the lender and borrower share the same Holmesian expectation: borrower will pay the loan principal plus agreed upon interest, or the lender will foreclose on the collateral. There is risk of loss, but the lender has already hedged against this contingency by setting collateral requirements and an interest rate it believes compensates for that risk. In fact, in the context of residential housing, the lender is in a much better position to assess the value of real estate, and therefore to adjust loan terms accordingly.

So it is possible that when a borrower voluntarily defaults, the lender has *already been compensated* for the costs of breach. And even if the lender is not fully compensated, the risk of loss is borne by the party who was in the best position to avoid it by properly valuing collateral. Placing the loss on the lender works in favor of the societal "good" of having price equate to value because it puts incentives to accurately value real estate with the correct party.

This is decidedly *not* so in the commercial context, where both the real estate investor and the lender are in equally good positions to value the underlying realty. Yet the use of single-asset entities renders most such debt nonrecourse, and thus places risk of overvaluation once again on the lender. Does this create the wrong economic incentives?

Probably not.

Most commercial real estate loans have a balloon payment at the end. There are at least two consequences of this structure. First, interest is front-loaded, meaning the lender collects its interest quicker, and thus has a hedge against the risk of negative equity. Second, the borrower bears the full risk of negative equity, because it must either sell the property or refinance it at the time the balloon payment is due—a near impossibility if the property value has declined substantially (and in the current meltdown, by as much as one-half). Opportunistic default allows the borrower to avoid a loss that is comparatively greater than that experienced by the lender, and also to invest money that would otherwise be used to pay on an underwater mortgage for alternative investments—another example of money funneling to its highest and best use.

If this is so, then why are opportunistic defaults—both residential and commercial—garnering such attention? I think the real issue is that so many mortgages have been securitized, which means the maker of the loan is not the party being damaged by the breach.

By its very nature, securitization disconnects the lender from risk of non-performance, and substitutes certificateholders in the lender's place. And certificateholders, depending on the tranche of certificates held, may believe themselves to have struck a very different bargain. The holder of AAA-rated certificates, for example, may *never* have contemplated foreclosure loss, and thus accepted a lower rate of return on the certificate. Opportunistic default, when it affects higher tranches in which the rate of return failed to account for such risk, damages a party who did not necessarily accept (or did not know he had accepted) the terms of the bargain.

In an effort to address this disconnect, the SEC has proposed regulations that would require issuers of mortgage-backed securities to retain a portion of certificates in each tranche—the so-called "skin in the game" requirement. That may cause an issuer to be more mindful of the risk profile of loans in the pool, but it isn't going to do much for investors who thought they purchased one thing, and found out they had another. And while the proposed regulations also call for greater transparency with respect to the assets in the mortgage pool, no amount of disclosure can shift the risk of loss from certificateholders to borrowers. That's a function of centuries-old contract law.

My point is this: Economic actors are only trying to maximize return within the legal framework society has provided them. The Dodd-Frank Act and Regulation AB are an attempt to alter that framework, but don't be surprised if there are unintended consequences. Only time will tell which perfectly rational industry responses to these developments will make headlines tomorrow as "ruthless."