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When It’s Better to Default on a Loan

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For the first 18 months of the crisis, attention had been focused mainly on the big players — banks, investment companies, hedge funds and the like. But in the United States and Europe, attention is now shifting to ordinary citizens. Banks are gradually returning to a normal state, but unemployment remains high and prospects for renewing steady economic growth remain uncertain.

We are now witnessing an interesting phenomenon in the United States, one that might very well usher in a new financial epoch. When the bubble burst on the U.S. real estate market, it placed 10 million American families in a serious bind. They were left holding mortgages costing more than the market value of their homes.

The rational response from an economic standpoint would be for those borrowers to default on their mortgages. Although they would lose the money that had already been paid, they would avoid incurring much larger losses in the long run. When the market value of a home is lower than the unpaid balance on the mortgage, borrowers benefit by defaulting because they are able to cut their losses.

According to traditional financial etiquette in most developed countries, however, mortgage holders usually do their best to pay off their debts regardless of the circumstances. But it turns out that this type of thinking is losing favor.

Once upon a time, mortgages were essentially transactions made between two parties — a borrower and a bank. That arrangement encouraged personal accountability on the part of the borrower. But now, the issuing bank might quickly sell off a bundle of mortgages to another financial institution, which in turn repackages them as derivatives and sells them on financial markets. All of this dilutes the direct relationship between the borrower and the bank and weakens the traditional sense of responsibility that a mortgage holder has to the bank. What’s more, many banks routinely default to free themselves of financial obligations, and this sets a bad precedent. Why should a borrower adhere to a higher moral code than the institution issuing the mortgage?

It is difficult to predict the consequences of this change in behavior. In his latest article, New York Times Magazine financial columnist Roger Lowenstein predicts that if enough borrowers default on their mortgages, banks that issue the mortgages will become far more willing to agree to new credit terms. That would in turn lead to new terms for mortgage credit, with banks — and not borrowers — having to insure against the risk of falling real estate prices. In the end, this should, in theory, increase market efficiency.

Will the emergence of this “financial postmodernism” have a negative impact on Russia? Only time will tell. One of the basic reasons why socialist economies have so much difficulty making the transition to capitalism is that they lack the deeply ingrained values and codes of conduct that exist in developed market economies. But now it appears that these values and codes are being eroded.

Before Russia has had the chance to complete the process of switching to capitalist values, it may be entering a new era in which paying off one’s debts is no longer considered a matter of honor.

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