CHAPTER 7

Irrational and Rational Homeowner Considerations

Abstract This chapter covers how homeowners and marginal borrower's irrational decision making using the *expedient* or *revisionist* pathway affected the housing market and what pathway they should have used to make more rational decisions in the real estate market. Real estate transactions examined in this chapter include the home equity loan, cash-out refinancing, and loan modifications.

Keywords Irrational real estate decisions · Expedient pathway · Revisionist pathway

In *Crash Proof*, Schiff and Downes remind readers that the American dream is to go from rags to riches by working hard and saving money and has nothing to do with owning a home. They see the "misconception of the dream and the importance given to home ownership" as a force that drove the housing bubble and affected the policies dealing with the bust (Schiff and Downes 2009). The US government drove this force. In 1993, the Department of Housing and Urban Development started taking legal action against mortgage bankers who denied more minority applicants than white applicants for mortgage loans. From then on until 2000, federal officials increasingly pressured lenders to relax lending standards so that people who would not ordinarily be eligible for mortgage loans would qualify (Sowell 2010). Lenders responded by lowering down payment and income requirements (Sowell 2010). Consequently, from 2000 to 2007,

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many Americans took advantage of the expansion of mortgage credit, and, by 2006, approximately 5 million marginal borrowers owned a home that they would not have owned had it not been for the credit boom (Mian and Sufi 2014). The extension of credit triggered rising home prices, which had an effect on existing homeowners who saw rising home equity as a way to finance home improvements and consume more (Mian and Sufi 2014). Then, when the housing bubble burst and home prices started to fall, homeowners who were substantially upside down in their properties tried to secure loan modifications to stay in their homes. Most economists agree that the decisions homeowners and prospective homeowners made during that time were as irrational as the decisions made by federal officials and lenders. Using Rodgers' six major pathways for decision making, it is obvious these decisions were made using the expedient pathway, where perceptual bias plays a dominant role.

In this chapter, we will discuss how homeowners and marginal borrower's irrational decision making using the expedient or revisionist pathway affected the housing market and what pathway they should have used to make more rational decisions in the real estate market. Real estate transactions that will be examined along the way include the home equity loan, cash-out refinancing, and loan modifications.

Irrational Real Estate Decisions Using the Expedient or Revisionist Pathway

As discussed in Chap. 2, the expedient pathway or revisionist pathway for decision making is the least time-consuming way to make a decision and the riskiest (Rodgers 2006). The decision maker relies heavily on his or her perception, which is influenced by education, cultural background, and personal emotions, and gives little consideration to available information (Rodgers 2006). During the housing boom and bust, the expedient pathway became the dominant thinking process for homeowners and prospective homeowner's financial decisions, as they got caught up in the "irrational exuberance" ignited by lenders and investors. Homeowners who borrowed equity from their homes via home equity loans or cash-out refinancing during the boom, marginal borrowers who purchased property for the first time when credit was expanded to them, and homeowners who sought loan modifications after the housing bubble burst all let emotional considerations drive their decisions and ignored reliable and relevant information that could have saved them considerable expense in

the long run. Home equity borrowers, driven by the irrational belief that house prices would continue to rise, were determined to maximize return on their investments. Marginal borrowers, driven by the misconception of the “American dream,” were determined to achieve a personal necessity (owning a home). And loan modification-seekers, driven by irrational emotional attachment to their homes and antiquated notions of meeting commitments with lenders, were determined to keep their personal necessity at any cost.

To better understand how the expedient pathway affected homeowners and prospective homeowners’ decisions, let’s look at each of the real estate transactions separately.

Home Equity Loans

A home equity loan provides cash proceeds to homeowners based on the equity (ownership amount) they have built up in their home (Homeloan.com). It is basically a second mortgage secured by the homeowner’s property (Pritchard 2016). This loan appeals to borrowers because they can borrow relatively large amounts of money and it is easier to qualify for than any other type of loan. Additionally, the home equity loan usually has a lower interest rate or Annual Percentage Rate (APR), interest cost that is tax deductible and low or no closing costs or other fees (Justin 2016).

From years 2002 to 2006, US homeowners borrowed so aggressively against the rise in home equity over half of the increase in debt for homeowners came from home equity loans. This aggressive response to house price increases significantly fueled the house-debt crisis in the United States (Mian and Sufi 2014). Surprisingly, however, homeowners with low credit scores (below 660) borrowed more aggressively than those with high credit score (Mian and Sufi 2014). Research shows that for every $1 increase in home-equity value, they borrowed approximately $0.40 cents and they spent the money mostly to consume more and improve their homes (Mian and Sufi 2014). Home equity loans nearly doubled during this period, going from a total of $593 billion in 2003 to $1.3 trillion in 2007 (Sowell 2010). Although this may seem rational to some people, many of these individuals had substantial credit card debt outstanding with high interest rates and they did not use any of the money extracted to pay down this debt, nor did they use any of the funds to purchase a new home or invest in another property (Mian and Sufi 2014).

Those who had bought and paid for their homes prior to the housing boom borrowed much more than they paid for their houses because they based their borrowing on the house's rising value during the boom (Sowell 2010). For example, if during the housing boom, a house that was bought in 1992 for $90,000 was worth $600,000, the homeowner could easily take out a $250,000 home equity loan on the home. While this may not seem problematic to some people, imagine a couple who, back in 1959, purchased a two-bedroom home for $11,500 and then had to foreclosure years later because their child refinanced the property several times and now the family owes over $400,000 (Sowell 2010).

The elderly also sought home equity loans and were offered what is known as a "reverse mortgage." This is a loan that does not require any repayment. Part of the equity is just transferred to the lender who holds it until the borrower dies and then turns it into cash at that time (Sowell 2010). During the housing boom, these loans increased considerably (Sowell 2010). In 2001, there were less than 8000 reverse mortgages while, in 2005, there were more than 40,000 (Sowell 2010).

In a 2004 *Fortune* magazine article, readers were warned not only that housing speculation was quickly "losing touch with reality" but also that the growing practice of borrowing against home equity was a risky business. The article summed up the situation as follows: "there's a real danger that a downturn in prices, or even a stall, could slam the economy, especially all important consumer spending. Americans have used their homes like ATMs, taking out $662 billion in home-equity loans and refinancings since 2001" (Sowell 2010).

Cash-out Refinancing

Cash-out refinancing, another form of the home equity loan, became very popular during the housing boom (Sowell 2010). Typically, when a homeowner refinances, he or she receives a new first mortgage and the existing home loan is eliminated (HomeLoan.com). The new loan usually has a lower interest rate than the previous mortgage and/or more favorable terms, such as a fixed rate rather than an adjustable rate. In cash-out refinancing, the new mortgage also includes the equity, which the borrowers get in cash (Amisano and Media 2016). Sowell gives the following example:

> Someone owing $300,000 on a mortgage with a fixed interest rate of 8 % could take out a new loan to replace the old loan when the interest rate fell

to 6 %. But instead of taking out another $300,000 mortgage loan at 6 %, the homeowner could take out a $400,000 loan at 6 %, paying off the existing mortgage loan from the proceeds of the new loan and keeping $100,000 in cash.

The lower interest rate often results in a borrower's monthly payment remaining the same, even though the mortgage was larger (Sowell 2010). Consequently, during the housing boom, the number of loans in this category rose significantly. In 2000, homeowners pulled a total of $26 billion out of their refinanced mortgages to spend as they pleased, while, in 2006, they pulled out $318 billion (Sowell 2010). "Cash-out" refinances made up 86 % of the more than six million home mortgage refinances in 2006 (Sowell 2010). Homeowners were not dissuaded from refinancing when most housing markets in the United States started to weaken in 2006 (Jurow 2010).

Lenders are required to report to the federal government under the Home Mortgage Disclosure Act (HMDA) (Jurow 2010). We can see "how total refinancing soared in 2002 as the Federal Reserve drastically lowered interest rates to minimize the economic fallout from 9/11" and how "refinancing in 2003 was simply off the charts" (Jurow 2010). We can also see how refinancing dropped to slightly less than 8 million originations in 2004. However, it is important to note that, according to Freddie Mac, approximately 40 % of the refinancing that occurred in 2004 was cash-out refinancing (Jurow 2010). According to real estate analyst Keith Jurow (2010), this was the year "when home prices really soared, by 30–40 % in the hottest bubble markets" and "cash-outs began to take off."

Marginal Borrowers and Credit Expansion

Prior to the credit boom, those individuals who could not secure mortgage credit—marginal borrowers—were renters. The mortgage application denial rate in areas with the worst credit scores (below 660) was 43 % compared to the denial rate of 16 % in areas with the highest credit scores (Mian and Sufi 2014). However, from 2002 to 2005, the availability of credit in low credit-score areas increased considerably. The increase led to 30 % more accepted mortgage loans per year in low credit-score areas until 2007, when more and more homeowners started to default on their loans and lending requirements tightened again (Mian and Sufi 2014).

The mortgage loans offered to the marginal borrowers with low credit scores and little or no down payment are known as subprime mortgages. These mortgages have higher interest rates than conventional loans, which are offered to borrowers with FICO scores 660 or above. If the loan was made on the basis of income information that was not verified, "stated income," then the interest rate was even higher, sometimes several points above traditional loans. Most subprime mortgages are also adjustable-rate mortgages (ARMs). Popular subprime loans were the option ARMs, also known as the 2/28. Features of the option ARM included the following:

- a fixed rate for 2 years;
- rate changes and fluctuations every 6 months for the next 28 years, with a 2 percentage point change beginning in the third year;
- cap rate of 6 points over the initial rate;
- prepayment penalty, which made refinancing more costly (Weintraub 2016).

Marginal borrowers irrationally accepted these subprime loans, when they should have put emotional considerations aside and paid attention to the warning signs that they were being duped by lenders. Economist Joseph E. Stiglitz summed it up this way:

> It was well known that the financial sector was engaged in all of these shenanigans, and it should have been a warning to borrowers, to the investors who bought the mortgages, and to the regulators. They all should have seen that mortgage origination was fee-driven: the borrower had to constantly refinance, and at the point of financing there were new fees—large prepayment penalties in settling the old mortgage and further charges at the issuance of the new mortgage. The fees could be recorded as profits, and high profits generate high share values for the mortgage originators and others in the financial sector.

The irrational reaction of marginal borrowers to the expansion of mortgage credit contributed to the astronomical increase in household debt in this country from 2000 to 2007; during these seven years, household debt actually doubled, rising to 74 trillion (Mian and Sufi 2014).

Loan Modification

A loan modification is an adjustment to the terms of a homeowner's existing loan by the lender. It may involve lowering the borrower's interest rate, reducing the principal balance of the loan, extending the length of amortization, and/or changing loan type (e.g., from a variable rate to a fixed-rate loan). Loan modification differs from refinancing in that the adjustment to the loan is usually temporary to assist the homeowner during a difficult time or through an unexpected hardship; however, the original loan is still in place (mortgageloan.com). Borrowers tend to seek loan modifications when they do not qualify to refinance their mortgage due to a low (below 620) credit rating (mortgageloan.com).

The problem is nearly all homeowners interested in loan modification are substantially "upside down" or "underwater" in their property. And, as economists Mian and Sufi point out, "underwater households are much more likely to default on their mortgage payments, either because the payment becomes prohibitively expensive or because of strategic motives." Therefore, it makes little sense to modify the terms of mortgage loans to help borrowers who are behind with payments when there is a good chance they will default on the loan later (Sowell 2010). For example, in 2009, the *Economist* magazine reported the following: "Of 73,000 loans modified in the first quarter of 2008, 43% were again delinquent eight months later" (Sowell 2010).

Emotional considerations influenced homeowners to seek loan modifications rather than default on their loans, even though, in some cases, default would have been a strategic move rather than a forced move. Defaulting generally has a negative connotation and borrowers did not want to feel irresponsible, shamed, or helpless.

However, lenders often played hardball with those seeking loan modifications. Below are four examples of homeowners who sought assistance from the law firm of McFarlin LLP to secure loan modifications.

Example 1

Farmers operating a dairy farm out of their home entered into a forbearance agreement with a lender after falling behind on their mortgage payments. Generally, a forbearance agreement is an agreement to postpone, reduce, or suspend loan payments for a designated limited amount of time. In this case, the forbearance agreement involved loan payment

reduction. Based on information (**I**) from the lender, it was the farmers' understanding (**J**) that the lender would permanently modify their mortgage after the completion of the forbearance agreement. The farmers, in other words, made the decision to sign the agreement using the analytical pathway (**I→J→D**). However, after they completed the forbearance agreement, the lender refused to modify their home loan and proceeded to foreclose on their home. Hence, apparently, the convenience of information was not complete in terms of reliability.

McFarlin LLP filed a lawsuit against the farmers' lender, contesting the nonjudicial foreclosure process and breach of the forbearance agreement. After the law firm obtained a temporary restraining order from the court, the lender offered the farmers a loan modification, which included over $500,000 in principal reduction.

Example 2

Homeowners Josie and Gerald F. were struggling to make their mortgage payments, as a result of mounting medical bills and loss of employment (I). Seeking relief, they perceived (P) that a loan modification would allow them to continue making monthly payments and keep their home. However, when they discussed the loan modification process with their lender, they were informed that they needed to become delinquent on their mortgage payments in order to qualify and be approved for any loan modification. This new information modified their perception, which, in turn, influenced their judgment (J) about making payments, and they became delinquent (D), as the lender advised. In other words, these homeowners viewed the loan modification process from a global perspective (**I→P→J→D**). However, after becoming delinquent, their lender refused to modify their mortgage.

McFarlin LLP filed a lawsuit against the lender, contesting the nonjudicial foreclosure process and false representations made by the lender. And, after obtaining a temporary restraining order from the court, the lender offered the plaintiffs a loan modification, which included over $330,000.00 in principal reduction.

Example 3

Joseph L. obtained a negative ARM loan with a lender, but was not informed that the rate on his loan would adjust. When it did, his mortgage payment increased from $750 per month to over $2,100 per month. Consequently, he contacted his lender and requested that

his rates not be reset. The lender told him he must become delinquent in order to qualify for any loan modification. Mr. L. did what the lender told him to do; he became delinquent. As a result, his lender refused to modify his mortgage. Apparently, Joseph L. implemented a revisionist pathway (**I→P→D**), since the lender information was "valid" and not taken as a key factor from the loan agreement for analysis (judgment) purposes.

Again, with the help of McFarlin LLP, Mr. L. filed suit against his lender, contesting the nonjudicial foreclosure process and false representations made by his lender, and the lender finally offered Mr. L. a loan modification, which included a substantial reduction in the interest rate on the loan.

Example 4

Mary J. was a homeowner who also struggled to make her mortgage payments as a result of the economic downturn. Seeking relief, she tried to obtain a loan modification from her lender for over two years but the lender continuously gave her the runaround. Then the lender finally told her that in order to qualify for a loan modification, she had to become delinquent on her payments. As with the previous examples, Ms. J. became delinquent, her lender refused to modify her loan, and she was at risk of losing her home.

McFarlin LLP brought suit against her lender, contesting the nonjudicial foreclosure process and false representation made by the lender, and, after obtaining a temporary restraining order from the court, the lender offered Ms. J. a loan modification, which included a significant reduction in the interest rate on her loan.

Rational Homeowner Considerations

During the housing boom and bust, homeowners and prospective homeowners would have experienced more cost savings had they used the analytical, revisionist, or global perspective pathway to decision making rather than the expedient pathway because these pathways involve making decisions with the aid of information. As mentioned in Chap. 2, the analytical pathway is one in which an individual identifies and analyzes all factors and alternatives before choosing the optimal alternative (Rodgers 2006); the revisionist pathway "highlights an unstructured environment

in which one may use all available information to influence perception before rendering a decision"; and the global perspective pathway "is where information adjusts one's perception that leads to judgment, then to a decision choice" (Rodgers 2006).

Homeowners who borrowed equity from their homes or refinanced them should have considered the following:

1. **Underwater Risk**. When homeowners borrow too much of home equity, they can end up underwater. The maximum amount to borrow should always be carefully calculated. Borrowers should do their homework. Rather than taking advice from lenders and loan brokers, they should research and analyze what real estate experts and economists are saying about the market today and what they are forecasting for the future.
2. **Possibility of Home Loss.** Home equity loans and refinance loans involve using one's home as collateral. Therefore, if something unforeseen happens in the borrower's life and he or she is unable to make the loan payments, the lender has the right to take one's home and sell it so that it does not incur a loss.
3. **Closing Costs and Fees**. Although these vary depending on the type of loan program one is offered, they can add up.
4. **Repayment Terms**. Borrowers should never overestimate their ability to pay off the loan quickly with high payments. They should consider all of their other financial obligations and factor in expenses that they know they will be responsible for in the near future. This is personal information at their fingertips. Therefore, there is no reason they should be making decisions without considering this. Borrowers may have the perception that they will be earning more money next year and want to include this in their process thinking, but other financial obligations are *real* and should not be underestimated.
5. **Teaser Rates Concealing Long-run Costs**. Teaser rates are interest rates "charged during the early months of a new mortgage" that were below even the unusually low interest rates being charged on mortgages in general during the housing boom. The unusually low initial monthly mortgage payments, made possible by the temporary "teaser" rate, would then be followed by higher monthly mortgage payments when the prevailing interest rate replaced the teaser rate—followed still later by another increase in monthly mortgage

payments when time came to begin repaying the principal on the mortgage loan (Sowell 2010). "During the height of the housing boom in 2005 and 2006, an estimated 15 % of adjustable–rate mortgages that were issued had initial interest rates below two %" (Sowell 2010). Borrowers should always consider whether they can afford to make the loan payment at its highest rate.

6. **Low Interest Rates/Balloon Payments**. While it is important for homeowners to obtain the lowest interest rate possible when borrowing equity from their home or refinancing, this information alone is not enough. They need to consider the other terms of the loan before making a decision. An interest rate may be low because a balloon payment is due a few years into the loan or it is an interest-only loan.
7. **Credit Score Affect on Loan Costs**. Although this may seem like a no-brainer, during the housing boom, some borrowers of home equity did not question (analyze) loan cost information as their primary concern was maximizing return on investment by borrowing against home equity. Waiting three to six months before applying for a home equity loan or cash-out refinancing could have made a considerable difference in some borrowers' lives as their credit scores may have been higher. As a rule, one should always keep credit card balances low, carrying no more than 30 % of one's available credit on any card.
8. **Private Mortgage Insurance.** Lenders may require this, if your current mortgage and what you are planning to borrow add up to more than 80 % of your home's value.
9. **Choice of Mortgage Broker.** During the housing boom, there was a lot of predatory lending going on. Homeowners should research brokers before doing business with them to make sure they are experienced and ethical.
10. **Comprehension of Loan Documents.** Lastly, homeowners should make sure they fully understand what they are signing. If they do not understand, they should get a lawyer or an analytical friend to review the documents before signing anything. According to Sowell, there are "indicators" that many "less sophisticated home buyers may not have fully understood how much their monthly payments could rise under adjustable rate mortgages with initially very low interest rates and sometimes an initial period of perhaps two years when they were paying only interest on their mortgage loan" (Sowell 2010).

Marginal borrowers should have considered the following before purchasing homes when credit was expanded to them:

1. **Closing costs and fees.**
2. **Repayment terms.**
3. **Teaser rates concealing long-run costs.**
4. **Credit score effect on loan costs.**
5. **Choice of mortgage broker.**
6. **Comprehension of loan documents.**
7. **Carry costs** (mortgage, taxes, insurance, utilities, upgrades, deferred maintenance, the cost of lawn upkeep or landscaping) of owning a home versus the cost of a comparable rental.
8. **Opportunity costs.** These are the costs of paying more than the cost of a comparable rental.
9. **Mortgage affordability.** Some prospective homeowner failed to acknowledge their own financial limitations before purchasing a home. They should have honestly asked themselves whether they could really afford the home they desired.

Homeowners who sought loan modifications after the housing bubble burst should have considered the following:

1. **Carry costs.**
2. **Opportunity costs.** When homeowners are upside down in a property, they should seriously reconsider their home investment because that money could be used elsewhere where it could possibly generate greater and more reliable returns. The best economic option would be to move into a rental property that is more affordable and save money for the next big real estate boom to recover current losses, unless it is projected that the time frame to return to an equity position is going to be short as indicated below.
3. **Estimated time frame for an upside-down Home to return to an equity position.** When a homeowner is upside down on their mortgage but the time frame for the home to be upside down is projected to be relatively short, then he or she should probably consider applying for a loan modification rather than foreclosure, which not only drives down the value of neighbors' homes and does not help in the recovery of the real estate market, but could negatively affect one's credit score for several years.

4. **Upside-down threshold.** When a homeowner is 20 % or more upside down on his or her mortgage and there is no short time frame projected for the home to be upside down, he or she should consider foreclosure or options for avoiding foreclosure, which will be discussed in the next chapter.

Summary

As Schiff and Downes indicated in their book *Crash Proof*, "getting rich by owning a home is not the American dream, or at least it was not the original American dream." From 1993 to 2000, the US government inflated the importance of homeownership by taking legal action against mortgage bankers who appeared to discriminate against minorities who applied for mortgage loans and then pressuring lenders to relax lending standards. Once lenders responded to this pressure by lowering down payment and income requirements, many American renters/marginal borrowers irrationally took advantage of the expansion of mortgage credit, which resulted in rising home prices and homeowners irrationally borrowing home equity through home equity loans or cash-out refinancing. And, when the housing bubble burst, some homeowners continued to behave irrationally by seeking loan modifications rather than walking away from properties they could not actually afford. All of this irrational behavior stems from the fact that, during this time, marginal borrowers and homeowners made important real estate decisions using the expedient pathway for decision making, which is the quickest way to make a decision but the more risky. They relied heavily on their perception of the opportunity before them and gave little consideration to available information, such as closing costs and fees, repayment terms, teaser rates concealing long-run costs, underwater risk, etc. They, in other words, underestimated risk and would have made better decisions had they used the analytical, revisionist, or global perspective pathway, all of which consider information as an important piece of the decision-making process. In *Freefall*, economist Joseph E. Stiglitz states that the government "has an important role to play: it should not only prevent the exploitation of individual irrationalities but also help individuals make better decisions" by taking action (monetary, fiscal, and regulatory) to help stabilize the economy (Stiglitz 2010). However, knowledge is power. Individuals should always arm themselves with information and not wait for the government to protect them from unscrupulous lenders and mortgage brokers.

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