Mitchell's Musings 3-12-12: Put Downs

Daniel J.B. Mitchell

For those of us teaching on the quarter system here at UCLA, the end of the quarter is coming soon. As a result, I have a briefcase full of term papers to read so my musing will be limited to one basic observation and its implication.

Michael Hiltzik, a business columnist for the *Los Angeles Times*, wrote an interesting column about the housing market a couple of weeks ago.[1] As it would be hard for anyone not to know, the Great Recession was triggered by the bursting of a housing bubble that then exposed a variety of flaky mortgage writing practices. The resulting financial fallout from the flaky mortgages is still being felt.

Hiltzik noted in his column that many homeowners now find themselves "under water." That is, the value of their home is less than their mortgage debt. Some of this deluge is the result of the decline in home prices after 2006-2007. But in bygone days when mortgage standards were higher, it was customary for prospective buyers to have to make a cash down payment of 20% of the purchase price of the house. With the mortgage thus being a maximum of 80% of the price, the house price could fall by 20% before the buyer was under water. And, since paying back the debt was amortized over the life of the loan, the margin between the home price and the remaining debt, other things equal, would generally widen over time.

However, the key point in the Hiltzik column was that those homeowners who found themselves under water and who simply walked away from the house, i.e., turned the home back to the lender, were viewed as moral failures. Bank and federal reluctance to provide debt relief by lowering the face value of the debt seems linked to this notion that national morality would be undermined if lenders had to write down their claims.

State law on mortgages varies and I am no legal expert but I can tell you that walking away from the house by an underwater buyer is the exercise of a "put." Here is an excerpt from a *Forbes* magazine website, explaining the financial term "put":

Put Options*: A put option gives you the right to sell a stock to the investor who sold you the put option at a specific price, on or before a specified date. For instance, if you bought a 25 October put option on Pfizer, the option would come with terms telling you that you could sell the stock for $25 (the strike price) any time before the third Friday in October (the expiration date). What this means is, if Pfizer falls anywhere below $25 before the third Friday in October, you can sell the stock for more than its market value. And if you don't want to sell the stock yourself, you can sell your option to someone else for a profit.*[2]

---

[1] Michael Hiltzik, "The Overblown Threat of Strategic Defaults," *Los Angeles Times*, February 24, 2012, available at http://www.latimes.com/business/realestate/la-fi-hiltzik-20120224,0,115088.column.
[2] http://www.forbes.com/2006/08/23/investools-options-ge-in_wh_0823investools_inl.html

Puts and their opposite number – calls – are standard fare in financial markets. In the example above, if the market price of a share of Pfizer stock falls below the $25 strike price, you can "walk away" from your share, leaving the seller of the put to make up the difference between the strike price and the lower market price. No one views someone exercising a put option in the stock market as doing something immoral. All that happened was that consenting adults entered into an options contract. The seller of the put undertook to carry the risk that the price of the stock might fall below the strike price. If that happens, the seller of the put loses. If it doesn't happen, the seller gains since the buyer paid a price for the unexercised put. The put therefore is a form of insurance, a stop-loss instrument that shifts the risk of a down market to someone else willing to take the risk.

Mortgages are also contracts negotiated by consenting adults. In effect, the mortgage has a put option built in of which surely the lender as a financial institution was aware when it agreed to the terms of the mortgage. The homeowner has the option to "put" the house to the lender, satisfying the debt. The lender may not want to take the loss or may have thought that the risk that the put would be exercised was negligible because, after all, everyone before 2007 knew that home prices would always go up.

So why is it moral to exercise a put in the stock market but immoral to do the same in the housing market? Why is exercising the home put sometimes termed a "strategic default," as if there was some fiendish cleverness in calculating that you owe more on a house than it is worth and exercising your put as a result?

Are there any financial advisors who, in the *Forbes* example above, would advise someone not to exercise a put on Pfizer stock if the stock was below the strike price? So why would an advisor think differently about the put in a mortgage? One reason, you might say, is that someone who puts the house to the lender will ruin his/her credit rating. But wait! Credit rating services would not downgrade the credit of someone exercising a put on Pfizer stock. (Indeed, it would be inadvisable to extend credit to anyone foolish enough *not* to exercise the put option if the stock fell below the strike price.) So just as we could raise the issue of why it is considered immoral to exercise the mortgage put, so – too – could we ask what justification there is for rating agencies to downgrade the credit of someone who exercises a house put. Why is a homeowner who makes the rational calculation that it does not pay to hold on to a house and therefore exercises a put a bad credit risk?

Now what, you might ask, has this excursion into finance to do with employment. A great deal, I would answer, since the recent data indicate that home prices are continuing to decline in many major real estate markets. The resistance to house puts is simply a way of trying to keep homeowners from exercising the options built into their mortgages. If homeowners were more willing to exercise their puts, lenders would be more likely to come to the table and write down the amount of the debt still owed to keep those homeowners in their homes. And federal policy would be forced to focus on encouraging such write downs rather than other palliatives.

Bringing the housing market into some kind of equilibrium would end the housing drag on the current slow pace of economic recovery. In the end, such write downs, if they kept people in their homes, would better preserve the housing stock in stricken neighborhoods. Lenders might actually benefit collectively if homes they owned were not abandoned and empty.

If a rose is a rose is a rose, at the end of the day, a put is a put is a put. A job is a job is a job and there would be more jobs if we treated "strategic defaults" as what they are: simple exercises of puts by rational homeowners.