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America's house price time bomb

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With the American housing market in its worst crisis since the Great Depression of the 1930s, President Bush is expected to sign into law a massive new government intervention designed to slow the slide.

The intervention would come as a little known quirk of US law threatens to drive down house prices even faster.

Faced with seemingly never-ending falls in the value of their properties, some American home-owners are taking radical action; they are choosing to walk away from homes and their mortgages.

In May 2006, at the height of the housing boom, Karen Trainer bought a $500,000 apartment in California – with money borrowed from her bank.

By this year, Karen still owed $500,000 on her mortgage, but her apartment was worth $200,000 less.

So she was deep in negative equity and, to make matters worse, the interest rate on her loan was about to increase.

"I thought 'this is crazy'," Ms Trainer says. "It just does not make financial sense."

Take the hit

As a successful professional, Karen could comfortably have managed the higher mortgage payments her bank demanded.

Instead, she decided to stop her mortgage payments altogether and let her bank repossess her apartment.

Her credit record will be badly damaged by the decision, but Ms Trainer expects this to recover soon.

"Generally speaking, within 5 years you are about back where you were, so my husband and I decided we'll take the hit and live with it."

Over to the bank

In California and much of the rest of America, there is a powerful incentive for homeowners such as Ms Trainer to walk away from their mortgage obligations.

Though banks can repossess and sell the homes of borrowers who stop paying their mortgages, under a legal quirk originating in the Great Depression of the 1930s, banks cannot easily pursue borrowers for any balance outstanding on the main mortgage on their homes.

Consequently, by walking away from her apartment, Ms Trainer has also walked away from the $200,000 loss on her property.

Her bank gets stuck with that.

Unthinkable option

Traditionally in America there is a social stigma attached to those who default on their debts, which should be a deterrent to walking away from your home.

But according to Susan Wachter, professor of real estate and finance at Wharton School of Business, in the depth of this crisis the social attitudes to such actions are changing.

“This is the kind of conversation that’s going on at cocktail parties, at swimming pools,” Professor Wachter says. “And suddenly this option which was truly unthinkable in the past becomes thinkable.”

Worrying development

Ms Trainer says she feels no moral obligation to go on paying a loan on a property that is going to go on losing her money. She says her friends support her decision.

“I think people are taking a more cold-hearted look at it,” she says.

“Is the bank going to pay for my retirement because I was a good girl and paid my mortgage, even though legally I didn’t have to?”

Professor Wachter believes that, to date, most people have had their homes repossessed because they could not manage the repayments.

The trend of people now positively choosing to walk away because it makes financial sense to do so is a worrying new development.

“The dangers are extraordinary,” Professor Wachter says.

“If all that is needed is that the house value is less than the mortgage value, there is a large number of homeowners in the United States who are in that situation”.

No renegotiation

In the city of Stockton – the foreclosure, or repossession, capital of the US for 2007 – estate agent Kevin Morgan sells repossessed houses on behalf of the banks that now own them.

According to him, walking away has become commonplace.

"I would say it's probably 70% of the volume of our foreclosures right now," he says.

"It's a business decision for their family that the smartest thing they can do is walk away from their home."

As a sign of the changing times, some 60% of borrowers do not even bother to contact their banks to attempt a renegotiation of their loan, Mr Moran explains.

"They stop paying and they stop talking," he says. "They just plain walk away."

Total disaster

It is impossible to know for sure how many of the people who are now walking away from their homes could have gone on paying their mortgages.

But Professor Nouriel Roubini of New York University, one of the first economists to warn of the dangers of the American house price boom, believes the number of people positively choosing to walk away is growing rapidly.

"This is becoming a tsunami of voluntary defaults," Professor Roubini says.

"The losses for the financial system from people walking away could be of the order of one trillion dollars when the entire capital of the US banking system is only $1.3 trillion.

"You could have most of the US banking system wiped out, so this is a total disaster."

Which is why it is not just US policymakers who are hoping America's new, multi-billion dollar initiative to stabilise the housing market will succeed in its aims and thus make walking away less attractive.

Because if it fails, the economic fallout could be felt far beyond America's shores.

Michael Robinson's two-part series "The Trouble with Money" is broadcast on 30 July and 6 August on BBC World Service. You can hear the programmes online by going to:

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