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What Happens When You Walk Away From Your Home?

REUTERS

By Chris Taylor | Reuters – 2 hours 13 minutes ago

It was just last summer that Charlotte Perkins made the hardest decision of her life as she and her husband Jim were caught in the vise of the housing bust.

Wanting to downsize their lives as they headed toward retirement, they bought a new house in Mesa, Arizona, before they sold the old one, also in Mesa. Their previous home had been appraised at nearly $400,000 at the height of the market, but as the housing crisis ravaged Arizona, they were told they'd be lucky to get $200,000 for it.

They were carrying a loan of $260,000 on their original home alone, meaning they were well 'underwater,' owing much more than it was worth. Combined with the mortgage on the new house, their housing payments had become an "anchor around our necks," she says, threatening to gobble up all their retirement savings and leave them with nothing.

The couple made a difficult call: They would do a 'strategic default,' and simply stop paying the old mortgage. "We really had to wrestle with it," said Perkins, 60. "We had worked all of our lives to build good strong credit, and we're proud people. But it came down to, 'Can we keep doing this?' We had to say 'No.'"

As the housing bust drags on, many homeowners are thinking like Perkins. Almost 11 million homes are now underwater, says financial information provider CoreLogic. Around 3.5 million homeowners are behind in their payments and another 1.5 million homes are already in the foreclosure process, according to online marketplace RealtyTrac.

As banks start to work through their backlog of distressed properties, the New York Federal Reserve estimates that 3.6 million foreclosures will take place during the next couple of years.

So, the question is: Does it make sense to keep paying a massive mortgage, knowing that it might be decades before a home regains its prior value? Or is that akin to - as columnist James Surowiecki recently wrote in the New Yorker - "setting a pile of money on fire every month"?

"I constantly get the saddest e-mails from people saying, 'I've exhausted all my life savings, my retirement is gone, and now I have to default,'" said Jon Maddux, CEO of YouWalkAway.com,

a foreclosure agency that helps clients with strategic default (and charges a fee for it). "But if they had seen the writing on the wall a couple of years earlier, stopped paying the mortgage and stayed in the home throughout the whole process, they would be in a much better financial position."

Moral Quandary

There's a moral component to that decision, of course. People naturally feel embarrassed about breaking a contract and not paying their bills; no one wants to be branded a deadbeat. But remember that companies default on their obligations when it makes financial sense for them to do so, via the bankruptcy process. Even the Mortgage Bankers Association itself, in a flourish of irony, arranged for a short sale of its Washington headquarters.

It's not personal; it's business. So think of strategic default as a business decision, and do a cold-eyed cost-benefit analysis of whether it makes sense for you, advises Carl Archer, an attorney with Maselli Warren in Princeton, New Jersey.

"People think it reflects on their integrity, and say 'I wasn't raised this way,'" said Archer. "But the more businesslike attitude is to say that there's a contract, there are penalties for violating that contract, and sometimes it just makes financial sense to break it."

The penalties largely revolve around your credit record, which admittedly gets blown up in the near-term. For a few years you can likely forget about qualifying for a mortgage or a car loan. When lenders are ready to take a chance on you again, you'll have to pay for the privilege, with stiff interest rates due to your default history.

What Happens to Scores

Charlotte Perkins watched her credit score go from a pristine 800 to 685, dropping every time she missed a payment. Credit-scoring firm FICO estimates that someone with a 680 score would see that number sink between 85-100 points after a strategic default, and someone with 780 could crater 140-160 points.

Not desirable, of course, but not the end of the world either. For Perkins, for instance, she already had a loan on her Ford Escape, and the mortgage on her new house, before she even started the default process. She hasn't seen any changes on her credit cards since, in terms of limits or interest rates.

Now that the previous home was auctioned off in December, she can start slowly rebuilding her credit, a process that should take about seven years.

Strategic default isn't a decision to be taken lightly, of course. If everyone did it, the housing market -- and the banks -- would be in much worse shape than they already are.

The following are some of the issues to keep in mind:

1. Look to it as a last resort, not a first option. Your financial troubles could be alleviated with a simple refinancing, especially since 30-year mortgage rates are near record lows of below 4 percent. If the banks are hesitant to rework your loan, look into the number of government programs designed to keep you in your home, which can be researched at MakingHomeAffordable.gov.

2. Location, location, location. Each state has its own rules and regulations regarding foreclosures, which affect both the length of the process and what you could be liable for in the end. In so-called 'non-recourse' states like Arizona, California and Texas, a lender cannot come after you for any deficiency (for instance, if your mortgage was $300,000 and they're only able to sell the property for $200,000). In other states they can pursue the difference, in theory - which is why some homeowners opt to file for bankruptcy, to free themselves from those potential obligations as well.

3. Use the interim to save like a demon. If you're in a state like New York or Florida, which require a judicial review of every foreclosure, it might be a couple of years before you actually have to pack up. In the meantime, be extremely disciplined about stockpiling cash. That will help you with a down payment for a rental, to pay for a car in cash if you need to, or to clear up other debts you might have. "Save money as if you were still paying the mortgage," says Archer. "If you don't, then you'll run out of both time and money, and then you'll be in a real tough spot."

4. Know the tax implications. Historically, if you have a debt that's forgiven, the canceled amount is considered taxable by the IRS. In the wake of the housing bust, though, the Mortgage Forgiveness Debt Relief Act was drafted to spare you those taxes. That legislation expires at the end of 2012, though - so if it's not extended, you could potentially face a tax bill for the difference.

5. Talk to a professional. A bankruptcy or real-estate attorney can help you through a very tricky process. The National Association of Consumer Bankruptcy Attorneys, for instance, has a searchable database of lawyers at www.nacba.org.

"Strategic default is not an easy decision, and there's a cost either way," said Gerri Detweiler, director of consumer education for Credit.com. "Would you rather be $200,000 underwater, or would you rather have seven years of damage to your credit report? It depends whether you're finally at the point where enough is enough."