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Your Money

Thoughts on Walking Away From Your Home Loan

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If you're among the millions of people who will not qualify for the Obama administration's program to help troubled homeowners, you're probably wondering what you're supposed to do now.

Perhaps you no longer have enough income to pay your loans. Or you can afford the payments but don't qualify for refinancing under the new plan because the value of your home is too far below the balance of the loan. If you're far enough underwater, you're probably questioning the wisdom of writing a monthly check on a place that may take 10 or 15 years to get back to the value it had two or three years ago. It isn't easy to come up with the answer, and if you have moral misgivings about not making good on your mortgage, a religious officiant may offer as much useful guidance as a financial planner.

In an economic environment like this one, however, the consequences of giving up on your mortgage may not be as painful as they were a few years ago. Yes, it's almost always preferable to negotiate a better deal on your existing mortgage than to walk away. But if you can't work things out with your lender, you probably won't be sued. You shouldn't receive a major tax bill either. And the damage to your credit will not be permanent or insurmountable.

Let's look at these last three in order.

YOUR LENDER First off, let's define what we mean by "giving up" on your current mortgage. It may mean trying for a short sale, where the lender allows you to sell your home for less than the mortgage amount. You may also hand over the deed to the home in exchange for the lender agreeing not to start foreclosure proceedings (a "deed in lieu" in industry terms). Then, there's foreclosure itself, and the possibility that bankruptcy judges may soon have the power to adjust the terms of primary mortgages.

That said, just because you're ineligible under the Obama plan doesn't mean that your lender or servicer won't ultimately adjust your mortgage anyhow. Collectively, there are enough people in trouble or under water on their loans that they have plenty of leverage if they're willing to play chicken with their lender and threaten to stop paying.

The problem is, the lender can play chicken, too, by threatening to come after you for the balance of any money you owe — whether it's the difference between what you sell the property for yourself and the remaining mortgage, or the loan amount left over after the lender sells your property in foreclosure.

The lender may not follow through, though. "What our membership is telling us is that it can be cost-prohibitive to chase down a borrower who is already in financial distress," said John Mechem, a spokesman for the Mortgage Bankers Association. "You can't squeeze blood from a stone." They may, however, still come after people with high incomes who walk away from jumbo loans that are way under water or loans on investment properties.

Some states have laws that may specifically prohibit lenders from pursuing borrowers for the balance of many mortgage loans after foreclosure, though the particulars vary. Arizona and California are among these states, according to Steven Bender, a professor at the University of Oregon School of Law. It's best to talk to a lawyer to determine your state's rules.

In fact, if you want to be sure your lender (or a collection agency that it may sell your loan to) won't chase you down, it's a good idea to have a lawyer involved with any short sale, deed in lieu or foreclosure itself. "You must get the bank to agree in writing that any deficiency is waived," said Chip Parker, a lawyer specializing in foreclosure with Parker & DuFresne in Jacksonville, Fla.

The biggest challenge here may simply be finding someone at the bank to help. Having a second mortgage will also complicate matters.

YOUR TAXES You also need to consider the taxman. Often, forgiven debts are taxable as income. Recent legislative changes, however, eliminate the federal tax burden through 2012 on most primary residence debt that a lender has reduced through loan restructuring or forgiven during foreclosure.

Mark Luscombe, principal analyst for CCH, a tax information service, said that people who sell their home through a short sale or give up the deed in lieu of foreclosure can also qualify for tax relief if they use a special tax form, 1099-C, that reflects the amount of debt that the lender has forgiven.

People who live in states with their own income taxes may avoid a big bill as well. Some states, like Arizona and California, have introduced or passed legislation that echoes the federal laws, according to the National Conference of State Legislatures. Many others tend to mimic most or all federal income tax laws as a general rule, according to CCH. Check with an accountant in your state to be sure.

YOUR CREDIT A short sale, deed in lieu or foreclosure itself will almost certainly damage your credit report and score, and the black mark will last for up to seven years. But the amount of damage it does will depend on how much other credit trouble you've gotten yourself into with other lenders.

If you're giving up the home you own, you'll probably need to rent soon afterward. Will landlords turn you away once they check your credit and discover your troubled mortgage? "If it's the only thing marring their credit, it's probably not a big issue," said Clay Powell, the director of the Rental Property Owners Association of Michigan, who added that good tenants could be scarce in economic environments like this one.

In fact, Todd J. Zywicki, a law professor at George Mason University, predicted that FICO may have to adjust its credit scores to lessen the impact of a foreclosure or similar incident. "It just seems obvious that a foreclosure in 2008 or 2009 doesn't have as much information value as a foreclosure five years ago," he said. "To the extent that foreclosure doesn't predict future behavior as much as it did in the past, you'd expect that the FICO algorithm would change to adjust for that."

Craig Watts, a spokesman for FICO, said that was an interesting idea. "We try not to get involved too much in psychobabble around what is and isn't predictive," he said. "If the numbers show that foreclosure is less predictive, then we'll take it into account in future redevelopments of the formula." That would take a minimum of two to three years, though.

Some lenders aren't waiting that long to initiate their own foreclosure destigmatization programs. The Golden 1, one of the nation's largest credit unions, now has a mortgage repair loan for people who have lost a home to foreclosure but want to buy a new one.

It's hard to imagine that there won't be a parade of insurance companies, credit card issuers and mortgage lenders in Golden 1's wake, even though Fannie Mae and Freddie Mac may be unwilling to guarantee the mortgages of such borrowers for several years. In fact, Aaron Bresko, the vice president of lending for BECU, another large credit union based in Washington State, is putting together a panel called "How to Lend to the Newly Credit Impaired" for a conference later this year.

"Good people have bad things happen to them, so how do you find those people and reach out to them?" he said. "As the year progresses, it's going to be an emerging market."