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Tips for Homeowners on the Brink

In a tough economic climate, many Americans are choosing to just walk away from their mortgages. Is that a good idea?

by Carl Winfield

Mortgage rates are skyrocketing. Credit is locked up. Economic pressures are rising. Time to bail on that McMansion?

Some homeowners who are three months to a year behind on their mortgages have chosen to leave their homes altogether. Anyone can walk away from a house—even a retired baseball great, Jose Canseco, who abandoned his Encino (Calif.) property earlier this year.

But attractive as "just walking away" may seem to a homeowner at the end of his or her financial tether, leaving a property to the mortgage-holder or other interested parties carries a serious credit risk and significant legal responsibility.

"The first thing you should think about is where you are going to live," says Benjamin Bradley, a partner at law firm Cohen Milstein Hausfeld & Toll. "You can always move back in with your parents, but it is better to just make an arrangement with a lender."

FORBEARANCE VS. FORGIVENESS

It is a good idea to call the person you may least want to talk to: The lender. Cash-strapped homeowners can get forbearance from their lender if they act early. This agreement reduces or suspends the mortgage payment for a limited time, giving homeowners a temporary reprieve.

A forbearance is not the same as loan forgiveness. Ultimately the mortgage payments have to be reinstated, and anywhere from three to six months of missed payments have to be accounted for. The very lucky—and reasonably well-off—can pay off the amount accumulated during forbearance in one lump sum. But for those who still find themselves in short-term financial trouble, most lenders offer specialized payment plans in which the borrower agrees to add a portion of the missed payments to the mortgage until the account is current.

"Lenders want to have borrowers tell them what is going on," says Traci Rollilns, partner at law firm Squire, Sanders & Dempsey. "It is cheaper to work with borrowers than it is to foreclose."

Speaking directly to a lender seems logical enough. But surprisingly, homeowners who struggle and fail to meet their mortgage payments month after month rarely contact their lenders. And the further they fall behind, the less likely they are to reach out for help. "Some people ignore their lenders if they cannot make their payments," says Brian Sullivan, a spokesman for the Housing & Urban Development Dept. (HUD). "They do not answer their phone. They throw the notices away. And then the house is in foreclosure."

By then, just walking away becomes much more attractive than trying to pay a loan for more than a house is worth.

A DRASTIC STEP

Walking away has not reached epidemic proportions yet. A survey released in June by You Walk Away, a Los Angeles company that advises people whose homes are in foreclosure, shows that fewer than 1% of homeowners nationwide have abandoned their foreclosed properties rather than make arrangements to pay off the mortgages. While Jon Maddux, principal and co-founder of the company, acknowledges that abandoning a home is not always in the best interest of cash-strapped homeowners, he argues the long-term rewards for doing so far exceed the risk.

"Walking away from a mortgage severely damages your credit," Maddux says. "But if you pay off your credit cards, get debt-free, and rebuild your credit that way, the foreclosure is gone after seven years. We've seen some of our clients' credit scores improve by 100 points after foreclosure."

Perhaps such a drastic step may help some homeowners. But even in the current housing market, those cases are few and far between.

"We are seeing more and more people who blame the market," says Anthony Casareale, an attorney with Akerman Senterfitt's distressed property practice. "There are those who abandon their homes and think 'I'll live to fight another day.'" But chances are, the people who are desperate enough to walk away from a house will never be financially secure enough for that brighter day to come."

PREVENTIVE MEASURES

Tighter lending practices and new legislation directed toward mortgage lenders could help revitalize the flagging market. But in the meantime, there are some quick and easy ways for homeowners to prevent mortgage difficulties from ruining their financial future:

• Contact either an FHA-sponsored or independent loan counselor to help you negotiate with your lender.

• Ask your lender about loan modification or changing the terms of the home loan.

• Find out if you are eligible for a partial claim, a one-time interest-free loan that will allow you to bring your account current.

Homeowners across the country are struggling to hold onto their investments amid a weakening labor market, rising inflation, and a sluggish economy. They may not always succeed, but by maintaining contact with lenders—and seeking out assistance from private and government entities—at least they have a chance.

"There are always options for homeowners," says Meg Byrne, director of HUD's Office of Single Family Program Development. "Nobody wants to see a neighborhood made up of boarded-up houses. And nobody wants to see anybody thrown out of their home."

Winfield is a reporter for BusinessWeek.