



Consumer White Paper

REThinking the Walk Away

by

Tara-Nicholle Nelson, Founder + Chief Visionary of REThink Real Estate

To Walk Away or Not to Walk Away? That is the question. Unfortunately, the answer is nowhere near that clear.

We “experts” are used to giving very concrete answers and opinions as to whether any given money move is a smart strategy (or not). And when it comes to walking away from your mortgage, even consumers have strong opinions: 80% of homeowners surveyed believe “it is morally wrong to walk away from a house when one can afford to pay the monthly mortgage.”ⁱ

However, two years of working with upside-down real estate consumers, their accountants and their banks and helping them navigate the impact of the economy and the real estate market on their family’s long-term wellness and financial well-being has taught me that ***the answer is just not that simple*** – there’s no single right answer that applies to every individual homeowner’s situation.

For some, walking away is an irresponsible and immature reaction to the inevitable fluctuations in the value of their home. For others, it might make more sense than the alternatives, not only financially, but also from ethical and psychological/emotional points of view. It boils down to a very personalized weighing and balancing of the many factors involved.

This white paper drills down into:

- what ‘walking away’ actually means (and doesn’t mean),
- the pros and cons of walking away,

www.REThinkRealEstate.com

- alternatives to walking away,
- the implications of walking away and, finally,
- the decision points that every smart homeowner *must* take into account when deciding whether or not to walk away from their mortgage.

Walking Away: What it Is + What it Isn't. The phrase 'walking away' conjures up the image of a homeowner packing up, locking the door and walking away from their home, abandoning it to their mortgage lender(s). In reality, walking away doesn't look much like that. In fact, homeowners who strategically walk away from their mortgages generally continue to live in their homes as long as possible without making the payments.

Walking away is slang for what is properly termed a **strategic default**: when a homeowner who can afford to make their mortgage payments stops doing so.

What walking away *isn't*. So, if you've been agonizing with the idea of walking away from your mortgage but you, in fact, cannot really afford the mortgage payment (either due to an upwards adjustment in the payment or a downwards adjustment in your income), I submit to you that what you're facing is not truly walking away. Rather, you might just be trying to set some benchmarks for when it makes sense to give up the struggle, the fight to keep your home.

Obviously, the concept of what any given homeowner can afford is debatable, as it seems there's always an expense that can be cut or a second job that could be obtained to make the difference between being able to afford your mortgage payment and not. But there is one *telltale sign* we in the industry look at to determine whether someone is executing a strategic default or truly cannot afford to keep their home.

True walk-aways typically have perfect payment histories for all of their bills and credit cards, then simply stop making only their mortgage payment, while continuing to pay the rest of their bills on time. Homeowners who let go of their homes because they can no longer afford them,

www.REThinkRealEstate.com

but are not intentionally, strategically defaulting, tend to fall behind on every other debt and bill they have before they will go late on their mortgage.

At the dawn of 2010, statistics show that about 26 percent of all foreclosure proceedings currently in process are strategic defaults, or walk-aways.ⁱⁱ

Why Walk Away? Homeowners, by nature, are inclined to do every single thing within their power to hold onto their homes. Even those who can't really afford to will beg, borrow and do everything but steal to avoid foreclosure. So what is the motivation behind a voluntary walk away?

There are really only three: being upside down, often in conjunction with either or both

- being squeezed, financially, and/or
- being frustrated with their loan modification or short sale negotiations with their lender.

Homeowners who owe more on their homes than they owe on them are often very concerned about how long it will take for their homes' value to recover, and *those who end up walking away generally decide they simply cannot afford to wait*. Sometimes, this is because they are severely averse to the financial reality of being upside down, or have other negative emotional reactions – anger, disgust, regret, etc. – to their situation. Other times, it's because they had a plan for retiring, moving, sending kids to college, etc. or another change of income or situation occurs and **they feel trapped - unable to make a geographic or life move they need to make and also keep up with the mortgage**.

My experience is that many of those who strategically default are already upset about being upside down, then are triggered to walk away when their degree of upside-down-ish-ness (e.g., negative equity) hits a critical point of intolerability, or a life event occurs that pushes them over the edge. Maybe they were okay with being upside down \$30,000, but when it hit \$100,000 or \$200,000 they couldn't envision the recovery anymore. I see this a lot with homeowners in the Boomer demographic and older – they can't see themselves working an

www.REThinkRealEstate.com

extra 10 or 20 years to make a payment on a house that they can't envision recovering, value-wise, in their lifetime.

Upside downers who have been in prolonged or unsuccessful negotiations with the lenders in an effort to divest the home via a short sale or make the mortgage affordable via loan modification may feel like they've already gone above and beyond in order to avoid walking away, and have even expressed a willingness to stay in an upside down mortgage strictly out of honor and their connection to their house itself. *When their lender's reaction to their short sale or workout request is rigid, reticent or ridiculous, the more upside down they are, the more likely they are to bail out when they realize there's no bailout.*

Options + Outcomes. As hard as it is, walking away seems to those who choose it like the simplest, cleanest way to closure and a fresh start. But it is certainly not the only alternative, nor is it without consequences

Options to walking away.

Staying put. There are lots of alternatives to walking away, the most obvious (to some) and least obvious (to others) being to sit still! For the average homeowner whose home's value has rolled back to what it was circa 2003, if you still have the same income, and your mortgage payment hasn't adjusted, it is highly likely that the smartest strategy is to stay put. If this describes your situation, nine times out of ten, the best advice is to keep making your mortgage payment and watch your home's value recover over the next 3, 5 or 10 years – the rate of recovery will vary depending mostly on where your home is located. Barring any unique life circumstances, the consequences of walking away likely dramatically outweigh any illusion of benefit for you.

Short sale. For those who must make a move, a short sale is the preferred route to take versus walking away. Counterintuitively, short sales take an excruciatingly long time, and your lender(s) might even ask you to make a large lump sum payment in exchange for their green light of your short sale. In most states, paying ten or twenty thousand dollars to a lender

www.REThinkRealEstate.com

to get the short sale closed just doesn't make financial sense (as the lender's only other option in most states is to take the home in full satisfaction of your outstanding mortgage debt).

But enough short sales are feasible and do get to closure to make it the smart first plan of attack for upside down homeowners who need to move and can't afford, for whatever reason, to rent their home out or otherwise continue to own it. The trick is to find an agent who has a strong track record of successfully closing short sales.

Loan modification. Negotiating with your mortgage lender(s) to reduce the balance, the interest rate or the monthly payment on your loan – is often held out as a valid alternative to walking away. However, the best loan modification candidates are people who have had a hardship or are struggling to afford the monthly mortgage payment (yet, paradoxically, can document sufficient income to make a modified payment). If you're flush with cash and simply upside down, the chances your lender will modify your loan are pretty slim. And if the modification you're looking for is an reduction in your principal loan balance, your chances are almost nil – only 1 percent of loans modified in 2008 involved any principal reduction. Of course, you could be one of the few who has success, so it's certainly worth trying for a loan modification before walking away.

Deed-in-lieu. I often hear commentators mention a deed-in-lieu of foreclosure as a good walk-away alternative. In real life real estate, though, a deed-in-lieu (where you literally sign your home back over to the bank, and the bank agrees to take it back) is just a very friendly walk-away. It's also not as easy to pull off as it sounds: your lender has to agree, and most require that you be several months behind on your mortgage payments and document the same level of hardship as they require for a loan modification. Most also require documentation that you've made an effort to short sell the place for at least 90 days prior to applying for a deed-in-lieu. The consequences of a deed-in-lieu on your credit, etc. are nearly identical to walking away or a "regular" foreclosure. So, while this is a preferred, orderly, amicable way to split from your home and your mortgage(s), it's not substantially different, in effect, from just walking away.

www.REThinkRealEstate.com

Bankruptcy. In a Chapter 13 bankruptcy, the judge is empowered to “strip” your primary residence’s second (and third, etc.) mortgages if the home’s value is no longer sufficient to secure them. Homeowners craving to stay in their homes, who see continued ownership as infeasible without significant property reduction should at least investigate this option. There are lots of negative impacts of bankruptcy, too, but it is an alternative.

Impacts of walking away.

Financial/tax. Strategically defaulting, on your home loan may free you up from tens to hundreds of thousands of dollars of debt, but it also has some potential financial disadvantages.

Here’s the worst case scenario: If you live in a recourse state,ⁱⁱⁱ your mortgage lender may have the ability to sue you for the difference between what you owed on your mortgages and. If you have any other financial assets, that may make you an attractive target. Right this moment, most lenders are so strapped for (wo)man power that they’re not suing any but the very most wealthy walkers-away. Nevertheless, if your state is on the list, be aware that this is a possibility and within your lender’s rights.

Beyond that, and if you’re in a non-recourse or one-action state, there might be tax consequences to be aware of. (Tax stuff is touchy – make sure you get your own tax pro’s input before making any real estate or mortgage decision.)

In a short sale or foreclosure, the difference between what your lender recoups and what you owed is usually seen as taxable income to you. However, through 2012, the Mortgage Debt Forgiveness Act authorizes the IRS to waive any taxes you would normally owe if your lender discharges some portion of your mortgage debt on your principal residence through loan modification, short sale or foreclosure, in most situations. There are definitely limitations, though – notably, if you had an equity line or loan on your home that was not used to purchase the property or refinance purchase debt (e.g., a line you used for a car, vacation,

www.REThinkRealEstate.com

tuition or medical expenses), and you walk away from that, the Mortgage Debt Forgiveness Act does not exempt you from being taxed on that amount.

IRS Publication 4861 provides an in-depth briefing on the tax implications of Canceled Debts, Foreclosures, Repossessions, and Abandonments,^{iv} and the IRS also offers a knowledge base on the Mortgage Debt Forgiveness Act.^v

Beyond that, there's an insolvency exception – if your total debts outweigh your total assets, debt walked away from might not be taxable in any event.

Credit. Walking away usually involves at least 6+ late mortgage payments and a foreclosure on your credit record. For this reason, many accounting and business professionals who recommend walking away (don't count me in that number, btw – it's too personal a decision for me to issue a blanket "recommend" in either direction) have their homeowner clients prepare strategically to be without access to credit for several years following a strategic default. They tell them to buy any cars and make any major financed purchases before they default. This has given rise to an ethically dubious practice known as the 'buy and bail,' in which a homeowner buys a new home at today's relatively low prices in preparation to bail from their existing home and mortgage(s).

The big question for most folks, though, is when they'll be able to buy another house. Current guidelines for FHA and most conventional loans prohibit a homebuyer from obtaining federally-backed home loans for 5 years after a foreclosure, but only 2 years following a short sale. However, (a) these guidelines change not infrequently, and (b) there are always lenders offering non-federally insured loans – those lenders might be willing to write a mortgage as soon as two years after a foreclosure, especially if all the rest of the borrower's credit is stellar.

Ethics/morals. Those who walk away break the promise they made to pay their loan. Some disagree that this should be considered in the context of a business decision, but I think it's an inextricable issue from the financial and other impacts of walking away from your mortgage.

www.REThinkRealEstate.com

While this ethical, moral commitment – and breaking it – should not be treated lightly, the topic warrants a revisiting to the original commitment that was made. When a lender and consumer come to a meeting of the minds in the context of a mortgage and decide to do this type of deal together, there are actually two separate agreements involved. The first is the note. The note is simply the borrower's commitment to pay – an IOU to pay the lender back the loan. This is the commitment that is broken when the borrower electively walks away.

However, there's a second agreement involved. This is called the Deed of Trust or Trust Deed. Interestingly enough, the Trust Deed is, essentially a prenuptial agreement. It reiterates that the borrower agrees to pay back the lender. Then it says, *but if* the borrower *doesn't* pay the lender back for any reason, the borrower and lender agree in advance that the lender can have the house back. Yes - the original relationship was created with an anticipation and planned, mutually-agreed outcome in the event of a breakup – I mean, default by the borrower!

Does that eliminate all ethical or moral dilemmas around walking away? Of course not – especially if it is truly elective. But it should put things in perspective that the lender understood and agreed up front that foreclosure and repossession of the property was an acceptable recourse to the broken promise. (Again, except in recourse states, where lenders generally reserve the right to come after you for the difference, if they have to foreclose on your home not just due to a strategic default, but for any reason.)

Emotional/psychological. I've heard many CPAs and business advisors make the point that corporations strategically default on debt obligations secured by devalued assets all the time. And often, if we're just looking at the debt and the value of the home, the obvious wise *business* decision would be to walk away. But not all corporations have ethics and morals, and most don't have emotions and psychologies and relationships and families that are impacted by their strategic defaults, so the parallel is not perfect.

www.REThinkRealEstate.com

There are big pros and big cons to walking away, in the emotional and psychological realm. Closure and fresh starts and clean slates (oh my!) are the upsides most people who walk away focus on – and these are very real impacts, especially when contrasted to the very visceral, energy bondage and mental and physical distress created by being \$200,000 or \$300,000 upside down, or more.

But there are big-time emotional impacts on the con side, too. Strategic defaulters may not take into account the grief and emotional trauma of losing a family home and major (albeit devalued) asset. They may not anticipate the regret and what-if wonderings that may haunt them: what if they'd stayed longer? Would the home's value have recovered? Would the lender have relented and eventually agreed to help? They might not account for the relationship issues that can result when one partner feels the other's bad mortgage decisions put them on the course to the walkaway, with all the credit and other implications entailed.

Conscious homeowners who crave to live in integrity with their finances must ask themselves when contemplating walking away: is this part of a pattern of overdebting or were you just caught up in market conditions beyond your control? (If you purchased your home much before the early 2000's, and are upside down, it's very possible the negative equity is due to discretionary borrowing against their homes, rather than just the decline in market value.)

There is a wise parallel here – the varying emotional and psychological impacts of walking away are similar to the different viewpoints on bankruptcy. Some see it as a legal and symbolic declaration of bankruptcy, which can be construed as connoting failure or depletion. Others see it as a simple restructuring or reorganization of debt to enable recovery and empower prosperity. And both, to some extent, are correct factually. What is critical is which viewpoint predominates in the mind of the homeowner making the decision.

Issues + Implications: rethinking the walkaway. Most experts and articles and guidebooks take either a purely business/financial approach (e.g., if you're X much upside-down on your home, ditch it and keep on moving; or the credit hit is too bad – don't do it). Or they take a

www.REThinkRealEstate.com

purely ethical, sermonizing approach that assumes the only 'right' is to stay in a loan (e.g., you signed the loan docs – you live with it – no matter what). The latter group means well, but is simply not dealing with the reality of unique situations or steeper negative equity than they could ever imagine.

I, on the other hand, have had hundreds of thousands of dollars in equity in my home, and I've experienced having over half a million dollars in negative equity on my home. My expertise comes both from working with homeowners as a real estate broker and attorney and from sharing their real-life experience and emotions in my own real-life real estate reality. So I speak with crystal clarity when I say there is no one clear answer, here.

The enlightened homeowner's thought process on the matter might go like this.

Issue #1: What are all the consequences of defaulting or not? Here's where you consult personally with a foreclosure attorney, a CPA, a Realtor®, your lenders, etc. to get an answer specific to your situation. If, on balance, you feel that defaulting would be to your 'desirable,' for the smart, conscious homeowner, it is necessary to ask,

Issue #2: Is it morally or ethically wrong to default? And if you *do* feel it is wrong, that brings up the question of,

Issue #3: Is the question of morality even relevant in this context, **in your personal value system?**

At each of these individual decision points, some serious factor balancing and weighing must take place. This is a grown-up, real, gritty issue here. *It is overly simplistic to think that this issue can be realistically understood or decided in terms of black and white, good and evil, right and wrong.*

In reality, it's often about **the greater good**. The *lesser evil*. What course of action – staying or walking – will inflict the *least* harm? Hence,

www.REThinkRealEstate.com

Issue #4: If it *is* morally wrong, are there any circumstances under which staying is even more wrong? Are those circumstances your current reality, or not?

For example, is there a level of negative equity beyond which you can't justify staying put? In one study of homeowners, zero homeowners said they would walk away because of 10 percent or less negative equity, but 17 percent would walk away if their negative equity reached 50 percent of their home's value.^{vi}

Is there a certain level of lifestyle or future or family sacrifice beyond which you won't go? If you have to sacrifice health insurance, or your children's ability to get a college education in order to afford your mortgage payment – which wrong is *more* wrong? Which right is more right?

Decisions + Divorces

In my mind, walking away from your mortgage (and, actually, foreclosure in general) is like getting a divorce. It's excruciating, has dreadful impacts on everyone involved and it is advisable to avoid it if at all possible. Notwithstanding which, it is also not fatal, and there are circumstances under which it, unfortunately, might be the lesser harm of the options before a particular homeowner.

Like a marriage, you and your lender exchanged vows. There are ethical and moral and karmic and psychological bonds involved, and breaking the vows disrupts or destroys these bonds. Most often, staying put works out in the long run. Sometimes, though, the damage created by hanging in there might conceivably outweigh the damage of a breakup.

I am neither judge nor jury, and the factual specifics of every homeowner's (and divorcee's) situation are unique. But to put this conversation about walking away into perspective, it is in no way reasonable to assume that the commitment between you and your lender is more sacred than the 'lifelong' commitment spouses forge at the altar.

www.REThinkRealEstate.com

No one is *for* divorce, and I'm certainly not *for* walking away. There is just not a clear-cut, right or wrong answer to the question "should I walk away" that works for everyone.

What I *am* for is making conscious, informed real estate and mortgage decisions with an understanding of how they will impact and shape your whole entire life – not just your money or your taxes, but your soul, your dreams and your relationships, too. Hopefully, this white paper has illuminated some of those impacts and painted a clearer, holistic picture of how walking away can impact your life, for better and for worse.



www.REThinkRealEstate.com

ENDNOTES

ⁱ http://www.financialtrustindex.org/images/Guiso_Sapienza_Zingales_StrategicDefault.pdf

ⁱⁱ http://www.financialtrustindex.org/images/Guiso_Sapienza_Zingales_StrategicDefault.pdf

ⁱⁱⁱ

^{iv} <http://www.irs.gov/pub/irs-pdf/p4681.pdf>

^v <http://www.irs.gov/individuals/article/0,,id=179414,00.html>

^{vi} http://www.financialtrustindex.org/images/Guiso_Sapienza_Zingales_StrategicDefault.pdf

Want to reprint or distribute this white paper?

Go for it.

But be advised that this work is licensed under the Creative Commons Attribution-Noncommercial-No Derivative Works 3.0 United States License.

To view a copy of this license, visit <http://creativecommons.org/licenses/by-nc-nd/3.0/us/> or send a letter to Creative Commons, 171 Second Street, Suite 300, San Francisco, California, 94105, USA.

www.REThinkRealEstate.com