Real Estate eNews

What's in Store for Walk-away Homeowners?

Going "underwater" has taken on a whole new meaning since the housing bubble burst in 2006. Home values escalated sharply in the previous decade, and rose even more drastically during the last two years of the bubble. When the dust finally settled, many homeowners found themselves locked into a mortgage that no longer reflected the value of their home. And when the job market deteriorated and massive lay-offs became the norm, home foreclosures began.

A second wave of foreclosures is now occurring, precipitated by property owners dubbed "walkaways". Walkaways are owners who have chosen to do just that, pack up and walk away from their home and mortgage. For some, the decision comes without a choice. Due to job loss or illness, they simply cannot afford to make their payments.

There is another class of "walkaways", made up of property owners who can afford to make their payments but choose to walk away regardless, or, in other words, engage in a "strategic default" on their mortgage.

What is a strategic default? It is the act of defaulting on a loan because the owner believes making the payments is no longer in his financial best interest. The owner arrives at this conclusion because the property in question, like almost all property in the U.S., has experienced a substantial drop in value. The debt owed by the mortgagee is greater than the value of the property, and the value is expected to remain low for the foreseeable future. The owner is then saddled with negative equity, or being "underwater" -- a state of owing a great deal more on a home than it is worth.

What will the decision to "strategically default" on a mortgage have on those that choose this action? No one is sure and opinions are divided on the legality and morality of such a decision.

When members of the U.S. House of Representatives passed the FHA Reform bill, they amended it at the last minute to prohibit walkaways from purchasing another house using Federal Housing Administration (FHA) funds.

The amendment makes homeowners who strategically default ineligible for an FHA-insured loan in the future. The representative introducing the rider to the bill, Rep. Chris Lee, explained, "If a borrower makes the decision to strategically default on a loan, they should not be allowed to benefit from a government-subsidized program." Currently, a new mortgage using FHA financing will take between three and five years after a foreclosure.

What other impacts could a walkaway experience? It's obvious that a foreclosure on a home will result in a negative report from credit-rating agencies, making it more difficult (and probably more expensive) for a borrower to obtain a loan in the future.

In the future, underwriters are expected to scrutinize an applicant's records more closely than ever. Finding that a borrower defaulted because of negative equity will be seen as a disincentive for a bank to make a mortgage loan.

Other lenders point out that while it might be tougher on walkaways, they may still be able to secure a loan, because loaning money is what banks do. And banks may view this market collapse in its entirety as "extenuating circumstances." Even if that is the case, lenders may, however, demand more from borrowers who walk away, than those who don't. They will likely need upwards of a 30% down payment and may be subject to higher interest rates.