

Forgiveness and Forbearance

There are two new words floating around the mortgage industry that we are hearing a lot about. Both fall under the umbrella of loan modifications and while they may sound enticing, any type of modification requires a little caution. What exactly do these words mean?

Forgiveness is basically a principal reduction. The mortgage company agrees to forgive part of the principal amount of a loan. Bank of America is the first to roll out this forgiveness program. According to a spokesperson for Bank of America, it will potentially affect 45,000 borrowers and total more than \$3 billion in debt write-offs. To qualify, the amount of the principal owed must exceed the property value by at least 20%, and the loan must be delinquent by 60 days or more.

Bank of America's program focuses on three mortgage products: 1) subprime loans, 2) mortgages with a negative amortization payment option and 3) 2-1 adjustable rate mortgages.

Through the five-year National Homeownership Retention Program, Bank of America will setup an interest-free forbearance account for the amount of principal owed above the current value of the home. For instance, if the borrower owes \$250,000 on a home worth \$200,000 and qualifies for the program, Bank of America will set up a separate account of \$50,000 that will sit alone without collecting interest while the borrower makes payments on the \$200,000 at the current market interest rate. There are no required payments on the \$50,000 non-interest bearing mortgage account.

For the first three years, Bank of America reduces the separate account – the \$50,000 in the example above – by 20% each year if the borrower remains current. Meaning after three years, \$30,000 would be forgiven in the example. If by then, house prices have gone up and the borrower is once again at a 100% loan-to-value ratio, Bank of America will no longer reduce the principal. If the borrower remains above 100% Loan-to-Value (LTV), Bank of America will continue reducing payments for an additional two years. Bank of America will not reduce the principal on the non-interest bearing mortgage account if the sum of both mortgages achieves 100% LTV.

Some financial analysts don't agree with this move saying they are forgiving "deadbeat debt". Studies have shown that 40% of borrowers who are given a mortgage modification end up defaulting a second time. Proponents of this type of modification believe it could be a lifesaver for many underwater borrowers and in truth, it could be. Wells Fargo is also considering some type of principal reduction modification program.



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Forbearance is the other new buzz word. This is a lender- approved reduction or elimination of your payments for a short time, which is usually a few months. This was created primarily for out of work homeowners for 3-6 months which should be enough time for the homeowner to find a new job and get back on their feet.

There are several qualifications the borrower must meet to be able to apply for forbearance:

- The borrower must meet HAMP (Home Affordable Modification Plan) eligibility
- The property must be owner-occupied
- The homeowner must ask for the forbearance
- Borrowers cannot be more then 3 months behind on their payments
- Must provide proof that they are receiving unemployment

The concern is that unemployment generally lasts longer then 3-6 months and getting forbearance could delay the inevitable. Once you find a job it may not generate enough cash flow to catch up on the back payments and continued payments.

It is wise to exercise caution when considering any loan modification, due to the potential effect on your credit. Since both of these modifications will affect your payment it will most likely show up as “paying under partial payment plan” or “paying under modified payment”. Both can have a negative affect on your credit score. And it could be a significant negative affect. Since forgiveness is relatively new, we haven’t seen lenders will report it. However, forbearance has caused quite a bit of damage to some borrowers credit scores.

In the end, always weigh your options when thinking of entering into a loan modification. What may sound like a perfect solution may come back to haunt you in the long run. So discuss it very carefully with your lender. If they tell you it will not affect your credit adversely, get it in writing so you can have something to go back to them with, if needed.

Loan modifications may be the answer for some but they won’t be a solution for every underwater or unemployed homeowner. Do your homework, talk to your lender and tread very cautiously through this new land of loan modifications.

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