

LOAN MODIFICATIONS

Hidden Risks:

The Good, The Bad & The Ugly Facts

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CHAPTER 1 – LOAN MODIFICATION 101: The Basics

1.1 Definition of a Loan Modification

A Loan Modification is a change to the original terms of a mortgage. When a borrower purchases property secured by a mortgage, the Lender will specify the terms of the loan. These terms include Interest Rate, Amount of the Loan, Terms of the Loan (number of years until the loan is paid off), Monthly Payment, and Amortization Schedule.

If the Borrower is unable to make the scheduled payments, then the Lender/Bank has some tough choices. The Lender may decide to Foreclose, accept a Deed in Lieu of Title or Short Sale or engage in a Loan Modification. If the Borrower can prove to the Lender that he has the ability to repay the loan if the Lender agrees to alter some of the terms, the Lender may agree to “Modify” the loan.

Here are some of the changes that may be made:

- Temporarily reduce the Interest Rate
- Permanent Interest Rate Reduction
- Change Amortization Schedule to allow an Interest Only loan (no principle repayment for a number of years)
- Extend the Term of the Loan.(ex. Stretch out the Loan from 30 years to 40 or 50 years)
- Any combination of the choices listed above.

The process of loan modification is an attempt to construct new loan terms where the borrower can consistently pay the mortgage payment plus all other household bills. The lender does not want to place the borrower in the situation where the mortgage payment consumes the major part of the family budget. The lender will take into account the entire budget, including car payments, utility bills, food, and credit card payments. The lenders “loss mitigation” department will consider all expenses that the borrower will incur to live a **normal life**.

You must understand that a loan modification is a **negotiation**.

1.2 WHAT TERMS OF A LOAN CAN THE BANK MODIFY

Interest Rate Reduction

Example 1

The easiest way to modify a loan is to lower the Interest Rate. When the interest rate goes down, so does the monthly payment.

A homeowner has a mortgage loan for \$250,000 at an interest rate of 7.50% amortized over 30 years.

The monthly payment at 7.5% is \$1748.04.

The lender agrees to lower the interest rate to 4.50%

The monthly payment at 4.5% is \$1266.71.

Savings is \$481.33.

In addition, the sum of the total payments over the life of the loan decreases.

Amortization Term Increase

Example 2

The typical mortgage term is 30 years. The loan is “amortized” or paid back with principle and interest over a 30 year period. In order to make the loan more affordable, the lender may offer to extend the term of the loan to 40 or even 50 years. Here is the effect on a \$250,000 loan at 7.5% for 30 years:

30 Year Term Loan. Monthly Payment is \$1748.04

Now, extend the Term of the loan:

40 Year Term Loan. Monthly Payment is \$1645.18. **Savings is \$102.86**

50 Year Term Loan. Monthly Payment is \$1600.58. **Savings is \$147.46**

Notice that the savings is small but the total payments over the term of the loan increases dramatically with an Amortization Term Increase. (a great advantage to the lender). This may be the least attractive option to the borrower.

Principle Balance Reduction

Example 3

Of all loan modification options, the Principle Balance Reduction is the most attractive to the borrower. The lender is actually reducing the balance due on the loan. For example, if the original loan was for \$250,000, the lender may be willing to reduce the balance down to \$200,000 in a severely depressed real estate market. Once accomplished, the lender is required to report this loss to the shareholders, and as a result, Principle Balance Reduction is the least favorite modification to the lender.

The Principle Balance Reduction has the effect of reducing the monthly payment and the total payments over the life of the loan. Example:

Original loan amount \$250,000 - Principle Reduction \$50,000= New Balance \$200,000

Interest Rate- 7.5% Term 30 Years

Monthly Payment on \$250,000: \$1748.04

Monthly Payment on \$200,000 \$1398.43

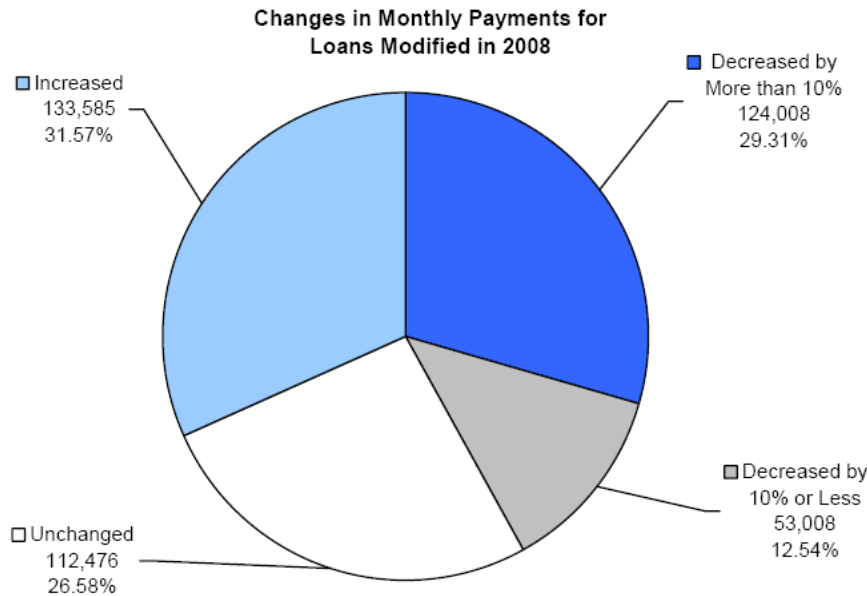
Savings is \$ 349.61

Not only does this reduce your monthly payment, the Principle Balance Reduction greatly reduces your total payments over the life of the loan.

These are just a few examples of how a Loan Modification can work for a homeowners situation. However, as you will see in the next Chapter, Lenders aren't as willing as we think to make these kind of changes to loans.

CHAPTER 2 – The Ugly Statistics

2.1 STATISTICS – CHANGES IN MONTHLY PAYMENT AMOUNTS



“Some statistics show that lenders are not making this process easy for homeowners and some Lenders are still increasing the monthly payments without reducing the principal amount owed on the home.”

Notice that more than 31% of Loans Modified, had payments that **INCREASED**. Also, when looking at the **Unchanged Payments** and the **Increased Payments**, over **58%** of Loans Modified either didn't have the payment changed or had the payment increased. This may come as a shock to homeowners when they are counting on a Loan Modification to remedy an already bad situation.

2.2 STATISTICS – GROWING RE-DEFAULT RATES

Modified Loans 30 or More Days Delinquent (30+ Re-Default Rate)			
Modification Date	Three Months after Modification	Six Months after Modification	Nine Months after Modification
First Quarter	38.8%	50.9%	57.4%
Second Quarter	44.3%	55.9%	X
Third Quarter	49.7%	X	X

A primary concern with loan modification efforts is the seemingly high rate of RE-DEFAULT. Within six months, over half of all modified loans were 30 days or more delinquent and over a third were 60 days or more delinquent (OCC and OTS 2008). Do these high rates of re-default imply that loan modifications are a risk for homeowners? Homeowners need to know the options before taking the risk.

CHAPTER 3 – Why Have Modified Loans Gone Bad Again?

3.1 Here's a look at six factors behind the trend:

1. Overextended borrowers: Many of today's most troubled borrowers are saddled with properties they were able to purchase only by overextending their finances through risky, adjustable-rate loans. Many of these borrowers got in so far over their heads that they won't be able to make their payments even in the most generous of modification programs.

2. Underwater effect: While loan modifications have reduced monthly payments for some borrowers, they haven't sufficiently addressed the issue of "negative equity," where a homeowner owes more on his mortgage than the home is now worth, says Christopher Thornberg, founder of Beacon Economics. "The modifications that they are doing don't solve the fundamental problem," Thornberg says. "The fundamental problem is that people's homes aren't worth anything close to the amount of debt that they are carrying on the home."

Homeowners who are "underwater" have an incentive to simply walk away from the house rather than continue paying off an investment that is losing value. Some borrowers could be telling themselves, "Well, gee, we've redone my mortgage, and it's still underwater so why bother [paying it]?" says Richard Moody, chief economist at Mission Residential. At the same time, home equity can provide borrowers with a financial cushion in times of distress. " But you have all these people who are now underwater and they have zero cushion," says Dean Baker, co-director of the Center for Economic and Policy Research. "So if anything goes wrong, they suddenly can't pay their mortgage."

3. Other debt: Some distressed borrowers aren't just behind on their mortgage debt; they have other creditors--their credit card company or a student lender, for example--hounding them as well. Such borrowers, in many cases, will have to use any cash that lower mortgage payments free up to pay off these other debts, meaning they're not getting much--if any--relief from the modification. "There are a lot of people that no matter how much you modify the mortgage, they are still not going to be able to deal with it because they have other serious financial problems," says Bert Ely, a banking industry consultant in Alexandria, Va. "They have a lot of other debt like credit cards, home-equity lines, student loans [or] car loans."

4. Moral hazard: Troubled borrowers who received a loan modification may simply be expecting a second round of modifications if they redefault, says Susan Wachter, a professor of real estate at the University of Pennsylvania's Wharton School of Business. “The moral hazard that is [potentially] operating is: For these households that are under stress, repayment plans have been negotiated, [so] the potential for renegotiating such plans upon default again exists,” Wachter says. Such borrowers could be thinking: “ ‘I couldn’t pay before. I can’t pay now. Let’s see what happens,’ ” she says.

5. Too-tough terms: It’s also possible that loans weren’t modified aggressively enough to make them affordable to troubled borrowers, Moody says. “In other words, when they underwrite these mortgages, they are underwriting them at a principal and interest maybe upwards of 40 percent of monthly income,” he says, “as opposed to what would be a more normal 30 or 32 percent.” Such loans might be significantly more affordable than they were originally, but the payments could still be too costly for distressed borrowers.

6. Unemployment: The economic and employment outlook has deteriorated significantly over the past six months. Job losses could also be preventing borrowers with modified mortgages from making payments.

CHAPTER 4 – The Options Available

4.1 Defining The Options

Option	How Does the Option Work?	Key Benefits
Repayment Plan	Distributes your delinquent payments over a period of time, usually no more than 10 months. A portion of the deferred delinquent amount is added to the normal monthly mortgage payment.	<ul style="list-style-type: none"> » Brings your account up to date within a specified time-frame. » With a goal in sight, you can move forward knowing that your mortgage loan is secure.
Loan Modification	A permanent change in one or more of the terms of the mortgage loan, allowing the loan to be reinstated to a "current" status, and resulting in a more affordable monthly mortgage loan payment. Past due interest and escrow are added to the new unpaid principal balance and re-amortized over the remaining life of the loan.	<ul style="list-style-type: none"> » Changes the mortgage note itself, giving you a "fresh" start on managing your mortgage loan. » Brings your account up to date immediately once the loan modification is executed.
Partial Claim (only for FHA loans)	A second mortgage, interest free, that is paid off at the time when the homeowner's loan is paid off. This option allows up to 12 months of past due accrued mortgage payments to be included in the second mortgage. Available only on FHA loans.	<ul style="list-style-type: none"> » HUD loan is interest-free. » Brings your account up to date immediately.
Fannie Mae HomeSaver Advance™ (FNMA Only)	A low interest rate loan provided by the first lien loan servicer to bring current a customer's delinquent first lien loan. The loan repaid over a 15 year term, with payment and interest accrual deferral during the first 6 months after the advance. Available only on most Fannie Mae loans.	<ul style="list-style-type: none"> » Brings your account up to date immediately. » Second mortgage is secured at a low interest rate.
Home Affordable Modification Program (HMP)	Goal of HMP: Help the most at-risk borrowers in default and those that are at risk of imminent default stay in their homes through a modification process to establish an affordable monthly housing payment. The goal is to reach a monthly housing payment (which includes capitalized past due payments, principal, interest, taxes, insurance and HOA/condo fees) that is no more than 31% of the borrower(s) total monthly gross household income. Note: The Streamlined Modification Program (SMP) and the Early Workout™ Program expired in March 2009.	<ul style="list-style-type: none"> » Changes the mortgage note itself, giving you a "fresh" start on managing your mortgage loan. » Brings your account up to date immediately once the loan modification is executed.
Short Sale	Allows you to sell your home and use the proceeds to pay off the mortgage if you are unable to maintain payments, even if the home's market value is less than the total amount owed.	<ul style="list-style-type: none"> » Avoids the lengthy legal process involved in foreclosure. » Typically less damaging to your credit rating than foreclosure.
Deed in Lieu of Foreclosure	Allows you to voluntarily transfer legal ownership of your property to your investor if you are unable to maintain mortgage payments and cannot sell the home at current market value.	<ul style="list-style-type: none"> » Avoids the lengthy legal process involved in foreclosure. » May be less damaging to your credit rating than foreclosure.

4.2 **Obama's Loan Modification Program – Things To Know**

Here are seven things you need to know about Obama's loan modification program.

- 1. Payments, not prices:** The plan centers on the belief that struggling borrowers will stay in their homes—even as values decline sharply—as long as they can make their monthly payments. Although not everyone agrees with this, billionaire investor Warren Buffett endorsed the philosophy in his most recent letter to shareholders. "Commentary about the current housing crisis often ignores the crucial fact that most foreclosures do not occur because a house is worth less than its mortgage (so-called "upside-down" loans)," Buffett wrote. "Rather, foreclosures take place because borrowers can't pay the monthly payment that they agreed to pay."
- 2. Thirty-one percent:** To that end, the administration's plan requires participating loan servicers to reduce monthly payments to no more than 38 percent of the borrower's gross monthly income. The government would then chip in to bring payments down further, to no more than 31 percent of the borrower's monthly income. In lowering the payment, the servicer would first reduce the interest rate to as low as 2 percent. If that's not enough to hit the 31 percent threshold, they would then extend the terms of the loan to up to 40 years. If that's still not enough, the servicer would forebear loan principal at no interest.

The plan does not, however, require servicers to reduce mortgage principal, which Richard Green, the director of the Lusk Center for Real Estate at USC, considers a shortcoming. "For underwater loans, if you don't write down the balance to be less than the value of the house, people still have an incentive to default," Green says. "Writing down the principal first, instead of last—which is what [the Obama administration is] proposing—makes sense to me."

- 3. Cash incentives:** To encourage participation, servicers will be paid \$1,000 for each modification and will get an additional \$1,000 payout each year for as many as three years, as long as the borrower continues making payments. Borrowers, meanwhile, can get up to \$1,000 knocked off the principal of their loan each year for as many as five years if they make their payments on time. Neither party can receive the cash incentives until the modified loan payments have been made for at least three months.
- 4. Financial hardship:** The Obama administration is pitching its plan as an effort to help responsible homeowners ensnared in the historic housing slump and painful recession—not

speculators. As such, only owner-occupied, primary residences with outstanding principal balances of up to \$729,750 are eligible. Occupancy status will be verified through documents, such as the borrower's credit report.

In addition, the program is designed to target homeowners who are undergoing "serious hardships"—such as a loss of income—which have put them at risk of default. To participate, borrowers will have to sign an affidavit of financial hardship and verify their income with documents. "If we would have had such stringent verification over the last four or five years, we probably wouldn't be in as bad a position as we are in," says Richard Moody, the chief economist of Mission Residential. But while Moody has no objection to such verification, obtaining documents from so many homeowners could be an onerous effort. "It's going to be a very time-consuming process," he says. Only loans originated on or before Jan. 1, 2009, are eligible, and modified payments will remain in place for five years. Now that the administration's plan is out, lenders are free to begin modifying loans.

5. **Net present value:** To determine if a particular mortgage will be modified, the servicer will perform a so-called net present value test. The test compares the expected cash flow that the loan would generate if it is modified with the expected cash flow it would generate if it isn't. If the modified loan is expected to produce more cash flow for the mortgage holder, the servicer is to restructure the loan. Howard Glaser, a mortgage industry consultant and a U.S. Department of Housing and Urban Development official during the Clinton administration, called this component of the plan "clever," arguing that it would work to ensure broad participation. "When you apply the formula, the loans that are modified are the ones that are in the best economic interest of the investors to modify," Glaser says. "The federal subsidy for the payment on the modification...tips the scale toward modification as a better deal for the investor."
6. **Second liens:** The Obama plan also addresses the issue of second liens—such as home equity loans or home equity lines of credit—by offering incentives to extinguish them. But key details on this component of the plan remained unclear. "Distinguishing the second lien is really important," Green says. "[But] exactly how they are going to convince the second lien holder to do this is not clear to me at all."
7. **Will it work?** Moody argues that while the plan may reduce foreclosures for primary residences, it could lead to a spike in defaults for another group of homeowners. Although he supports the administration's efforts to focus the initiative on primary residences, Moody

notes that "it could be the case that a lot of [real estate speculators] have been just hanging on waiting to see exactly what the details are of this [plan]," Moody says. Now that it's clear the Obama plan leaves speculators out, "we could actually see a spike in foreclosures or at least mortgage defaults among this group."

CHAPTER 5 – The Questions

5.1 Do I have to be behind on payments to qualify for a Loan Modification?

While most loan modifications are done for those who are behind on mortgage payments and can show a substantiated reason for why they cannot catch up, you don't have to be behind to qualify for a mortgage modification. The best thing to do is contact us today so one of our specialists can look at your case.

5.2 Can missed payments be included in a Loan Modification?

Past mortgage payments that went unpaid can be included into a loan modification. A willingness to get caught up in your current mortgage can show the lender how serious you are about making any new mortgage terms a top priority.

5.3 How long does it take to do a Loan Modification?

Because each homeowner's situation is different the time needed to qualify for a loan modification can vary. Typically a modification takes between 2 weeks to 4 months.

5.4 Will the bank require an interior inspection of my home?

An interior inspection of your home could be necessary as a means to determine whether a loan modification is a viable option. This inspection is meant to determine the value of the home.

5.5 Are Lender Loss Mitigation Representatives hard to talk too?

From the Lender's point of view, Loan Modification is really the process of stopping or minimizing loss. That is why they call their department the "Loss Mitigation Department" not the "Loan Modification Department". Most loss mitigation representatives are easy to speak with if you know how to do it. The trick is to discover what they want and how they want it.