

More underwater homeowners to get cuts in principal balance

Lenders have resisted forgiving debt as part of mortgage modification programs, but the outlook for that step is changing.

By Kenneth R. Harney

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Reporting from Washington - For hundreds of thousands of homeowners who are underwater on their mortgages, it's been a tantalizing question: Is there any way that our lender might agree to lower the amount we owe -- not just the monthly payments but the principal debt itself?

Until now, the answer almost always has been a resounding no. Lenders and investors were willing to cut interest rates, reschedule payments, even write off some late fees, but they were dead set against forgiving even a dollar of the principal balance.

The Obama administration's loan modification programs had sidestepped the subject as well, focusing on lowering troubled borrowers' monthly payments to more affordable levels rather than wiping out debt.

But the outlook for principal reductions is on the verge of change. Bank of America Corp. recently unveiled the mortgage industry's first large-scale principal forgiveness program, potentially involving up to 45,000 underwater borrowers and \$3 billion in debt write-offs.

And on Friday, the Obama administration announced measures aimed at getting lenders to reduce underwater borrowers' principal balances and refinance their mortgages into government-sponsored loans. The changes could affect modifications offered by substantial numbers of banks and mortgage companies.

BofA's new program targets borrowers who are deeply underwater -- those with loan-to-value ratios of 120% or more. This means they owe at least 20% more on their mortgage balances than the current market worth of their homes. There is no upper limit on how far underwater borrowers can be, but the program has a 30% maximum reduction of any principal balance.

Barbara Desoer, president of BofA Home Loans, said the program attempted to address the problems of the most "severely underwater mortgages with some of the highest rates of delinquency," and could "become an industry model for principal reductions" on a far broader scale.

The program targets three mortgage products popular during the housing boom: subprime loans; payment-option mortgages with negative-amortization features; and "2-1" adjustables that offered teaser interest rates for the first two years, then converted into loans whose rates adjust once a year.

As part of its ongoing loan modification efforts, the bank will look to phased-in principal forgiveness as the first step toward keeping an underwater borrower out of foreclosure. Previously the bank looked first to lowering a homeowner's interest rate and monthly payments.

Here's how it will work, according to BofA officials: Say you're deeply underwater on a subprime mortgage that you took out from Countrywide Home Loans, which was acquired by

BofA in 2008. Say your mortgage balance is \$250,000, but your house is worth only \$200,000.

If you're eligible, the new program could reduce your balance by \$50,000 and your new payments would be based on the lowered principal debt and possibly a lower interest rate. This would be accomplished by the creation of an interest-free forbearance account covering a five-year period. Assuming you made regular payments at the lower amount during the first year, \$10,000 would be forgiven by the bank.

The same would be true for the second and third years. By that point, \$30,000 of your principal debt would have been extinguished. During the fourth and fifth years, the bank would appraise your property. If its value had appreciated in either year to the point where your loan-to-value ratio had dropped below 100% -- you were no longer underwater but still benefiting from the lowered payments -- there would be no forgiveness that year. If you remained underwater, you would receive the scheduled \$10,000-per-year principal reductions, extinguishing the full \$50,000 during a five-year span.

For certain payment-option loan borrowers who are underwater in part because of the negative amortization features of the mortgage, the bank will forgive the negative amortization amount down to a 95% loan-to-value level.

Without fanfare, Wells Fargo, the country's largest volume lender, also has moved to selectively offer principal reductions for certain underwater payment-option loans.

With the Obama administration supporting the concept, principal forgiveness might well become a lifeline for a much wider group of homeowners.

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