HONEY I SHRUNK THE MORTGAGE

TO MODIFY OR NOT TO MODIFY WITH A <u>PRINCIPAL REDUCTION</u> UNDER TREASURY SUPPLEMENTAL DIRECTIVE 10-05 (June 3, 2010)

By: Kenneth B. Schwartz, Attorney
555 Westbury Avenue
Carle Place, N.Y. 11514
Tel: 516-333-7020

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Kenneth B. Schwartz, Esq.
555 Westbury Avenue
Carle Place, N.Y. 11514
516-333-7020

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To Modify or Not to Modify with a <u>Principal</u> <u>Reduction</u> under Treasury Supplemental Directive 10-05 (June 3, 2010)

By: Kenneth B. Schwartz
555 Westbury Avenue
Carle Place, N.Y. 11514
Tel: 516-33307020

Say your home value went down like "Honey I Shrunk the Kids" and your mortgage didn't budge or it grew a bit with all those late charges and the last three months that still sit on the kitchen table, hoping and waiting for a little extra cash to clear the bank. Not a pretty sight when your mortgage stands a head taller than your house with no end in sight as Treasury tries to find itself - and all those programs seem to help everyone except you. So … take heart and not to despair, here's the multi billion dollar question.

Will your bank take a write down so house and mortgage can stand side by side without a step stool. Or, are you stuck forever in one of those inter galactic time warps where nobody really gives a crap so don't think too deeply and just get even - you'll show them a thing or two and take a few politico's off the holiday mailing list. Nobody messes with you, right?

Or, are you better off in a short sale where lender lets mortgage go for cents on the dollar knowing they'll save a bundle by not having to go through foreclosure or some other legal mess with lots of red ink.

Well, here we go, right off the press from downtown Treasury USA we have the latest in single spaced, supplemental directives to let everyone know that Washington walks among us and not to worry, help has arrived. Blow the bugles but don't get too wild and crazy, first read on.

Like a two ounce steak for an army of seventy seven, Treasury has offered a bite sized tidbit for a small minority who are disciplined and resourceful enough to tough out the market and hold on till the market changes. Behold, Treasury Supplemental Directive 10-05, hot off the press. Here's how it works.

Relief for Homeowners

For those fortunate enough to qualify, the program provides for a potential write down of loan principal over a three year period, so the loan to value ratio as determined through either broker pricing opinions or automated appraisals from sales of comparable properties – would end up being somewhere between 105% and 115%. To figure this out, Treasury plans to issue a brand new computer program called NPV 4.0 so all the banks can take your raw info and toss it into a black box that'll know anything and everything about who should sink or swim, almost like lifeboats on the Titanic with R2D2 saying who goes first. According to Treasury, for folks to qualify it's a matter of deciding two big questions. One, can a borrower meet all the requirements that are within his power to meet. And two, even if a borrower passes with flying colors, will it benefit the bank to modify its mortgage.

Borrower Requirements

To Treasury, it's a matter of reaching that mystical front end "DTI Ratio" that everyone should strive to achieve if they truly want inner peace and sanctum, a ratio of monthly debt to income equaling 31% after taking into consideration all monies due on a monthly basis on your first mortgage only, inclusive of taxes and insurance, and comparing that to monthly gross income which your lender can verify with third party doc's like W2's, pay stubs and tax returns. Divide payments into income and there you have it, presto, your Front End DTI that's got a have a "3" and "1" – in that order. Mess up and you're done. And forget the numerology – play Lotto.

Now, to achieve a "Front End DTI" of 31%, Treasury's black box will try three things in this precise order:

First, lower your interest rate to an amount not less than 2%.

Second, increase amortization of principal to a term not exceeding 40 years.

Third, write off loan principal so the overall ratio of loan to home value ("LTV") will fall somewhere between 105% and 115%. Huh ? Let's try that again.

As a last resort after lowering your interest rate and increasing the term, Treasury says, look to home value by way of an automated appraisal based upon recent sales of comparable properties, or an opinion letter from a real estate broker who's in the know, someone who does business in that area. Take that value plus another 15%. If your mortgage exceeds that 115% figure – 115% of value – then Treasury says that if a principal reduction would allow you to achieve a 31% DTI, after having reduced the interest rate and extending the term, then and only then, your lender may treat you as being eligible for consideration. Fabulous, right?

Modification Must Benefit Lender

So let's see, are we saying that even if a borrower jumps through every hoop and dances on a bed of scorching coals without missing a beat – are we saying that Treasury's black box, NPV 4.0 to you, may still do a bid "D" for denied and turn the borrower down. Yep – exactly. Now we're talk'n.

Treasury says it's all in the "Waterfall Analysis", either in standard or alternative form. Pick your poison.

Huh? Waterfall? Water – who?

No, we're not talking Niagara or anything to bathe in – computers don't do stuff like that. They're stuck in a black box with no way out, much like solitary or a 23 hour lock down on the Green Mile.

Waterfall refers to a type of financial analysis that gives your best prediction of what may occur at a specific point in time. So for instance, you may predict $1 in revenues for the calendar year as of January 1st, $2 for the year by June 1st and one billion as of December 1st. The variations are important, often instructive as to what changed and why.

That said, Treasury has made a huge fuss over "Waterfall Analysis" by saying the Black Box will do a present value calculation – discounted cash flow study to you – to see if a mortgage modification can create a higher cash flow for the lender. More cash, more profits. More profits, more comp. More comp, more fat for the fat cows. Got the idea?

So if Waterfall Analysis shows more cash coming in after doing a modification, then it's a heads up and the modification moves on to wherever modifications may go. If not, thumbs down and the big "D" – denied.

But it's not that easy – sorry.

Treasury says that Waterfall Analysis will come in two flavors, "Standard" and "Alternate." If cash flow doesn't improve from a modification using the "Standard Waterfall Analysis," then Treasury's Black Box will do an "Alternate Waterfall Analysis with different assumptions to see how it comes out. Hmm…

A better cash flow from an Alternate Waterfall Analysis, will mean that a lender may proceed with a modification, only if it wants to, unlike a better cash flow from the Standard Waterfall Analysis where a lender doesn't have the option of saying no.

So, put all this together and what are they really saying in waterfall talk. Simple.

Those who are current on their payments that find themselves underwater, need not apply. No relief for them since a discounted cash flow must always come out higher for folks who pay more, not less, so no lender would ever stand to benefit by reducing the payments for someone who's current, plain and simple. To get relief under this program you must default and stay there.

Eligible Mortgages

Pretty cut and dry for most of us:

Loan Amounts – Current Unpaid principal not more than,

- $729,750 for one family houses
- $934,200 for two family houses
- $1,129,250 for three family houses
- $1,403,400 for four family houses

Type of Property – Owner occupied, principal residences only. One to four units. No investor or second homes.

Type of Mortgage – Non Fannie and Freddie, period.

Ratio of Loan to Value – Greater than 115% or in other words, mortgage tops house by 15%.

Starting Date – October 1, 2010 unless your bank decides to start sooner.

Default and Hardship – Only those who suffered a hardship that either defaulted or who stand in imminent danger of defaulting. Don't even think about a principal reduction if you're current.

Other Program Requirements

Proof of Income – You must prove your income by way of income tax returns with authorizations allowing your lender to obtain copies directly from IRS, plus W2 forms and/or pay stubs. For those who are self employed, Treasury will allow other documentation, things like bank statements and financials.

Back End Debt to Income Ratio – The rules say that if your overall debt to income ratio comes out to 55 percent or more, lenders must refer the matter for debt counseling. This would not, however, automatically disqualify folks from consideration. Just a little discomfort.

Court Proceedings – Foreclosures and bankruptcies, bring'm on. No problem. Just make sure you're in default.

Program Benefits

Principal Reduction – Reduce unpaid principal to somewhere between 105% and 115% of home value in order to achieve a "Front End DTI" of 31% (<u>see</u> Borrower Requirements, above). And that's the limit – the minimum amount necessary to reach a ratio of monthly mortgage payment to income of 31%. Then, take the entire principal reduction and divide by three. That's the write off you'll get at the end of each year for three straight years providing you stay current. Once written off, each of the three reductions will become rock solid, but fall behind and you'll kiss any further forbearances goodbye.

Credit Reporting – As each installment gets written off, lenders must update their numbers with each of the four major credit reporting agencies. It's unclear from Treasury if the principal reductions will get reported as a write off, damaging to one's credit history, or just an overall restatement of the balance being due without any lasting scars.

Income Taxes – No taxable income in most situations if you took out your mortgage when you bought the house. If not, if you refinanced and cashed out, then you may have a tax liability. Those who owe more than they own – who qualify as "insolvent" – won't owe income tax to that extent. Best to talk tax with your tax advisor if you're not sure.

About the Author

The author Kenneth B. Schwartz is a practicing attorney who maintains offices at 555 Westbury Avenue, Carle Place, N.Y. (Tel. 516-333-7020). After becoming a certified public accountant in 1980, Mr. Schwartz earned his JD in Law from St. John's University Law School in 1983, and a Masters in Tax Law from New York University in 1991. Mr. Schwartz now devotes his law practice to the representation of buyers, sellers and lending institutions in connection with real estate closings.

Mr. Schwartz resides on Long Island together with his wife and three children.

Mr. Schwartz's prior publications on the real estate industry include Mortgages to Music (Morris Publishing, 2004), CEMA's, a Tale of Two Mortgages (Xtreme Publishing, 2006); Cooperatives and Sandcastles in the Sky (XTreme Publishing, 2007); CEMA's and Darwinian Evolution (Mortgage Press, October 2007); Short Sales, Our Secret to the Universe (Mortgage Press, December 2007); Mortgage Closing Resolutions for 2008 (Mortgage Press, January 2008); The Shady Short Seller (Mortgage Press, February 2008); Should Have Done A Short Sale, Bankruptcy vs. Short Sale (Mortgage Press, March 2008); Short Sale Scams Alive and Well and Living in Scamsville USA (Mortgage Press, June 2008), Let's Talk the F Word, an unabridged Crisis (XTreme Publishing, 2008); Just a Glimmer – Short Refi's, Hope for Homeowners under the New Housing Bill (Mortgage Press, 2008); Just a Few Bil (XTreme Publishing, 2008); Thou Shall not Pump and Dump (Mortgage Press, 2008); Stuck in the Spirit of Holiday Giving (XTreme Publishing, 2008); Short Sales in the Ancient City of New York (XTreme Publishing, 2009); Don't Pay Your Debts, "The Financial Vigilante" (XTreme Publishing, 2009); Pre-Approving the Short Sale (The Corridor, 2010); The Tax Man No Cometh on Short Sales (The Corridor, 2010).

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WOW, YOU MEAN THE BANKS ARE REALLY TAKING A WRITE DOWN SO FOLKS CAN GET THE RED INK OFF THEIR BALANCE SHEETS AND MOVE ON? IMAGE THAT. IMAGINE A WORLD WITH HOUSES AND MORTGAGES WHERE FOLKS MAY ACTUALLY SELL OR REFINANCE AND WALK AWAY WITH CASH.

DOESN'T SOUND REAL, DOES IT? OR MAYBE THE FEDS FINALLY FIGURED IT OUT, SO MAIN STREET CAN SHARE IN ALL THOSE BILLIONS AND GET THROUGH THE MESS.

THINKING ABOUT A PRINCIPAL REDUCTION TO BREAK EVEN – READ ON.

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