



## **RECOVER & REBUILD**

When a homeowner finds themselves upside down in their mortgage payments, they have no idea of which direction to turn, and it seems that it is almost impossible to get straight answers to their questions about what options they have, and how each option will affect their credit. Following is information to help you answer those questions. Remember, there are NO quick fixes when it comes to credit, so it is imperative that you don't wait until the last minute to get this information out to your clients, and your prospects, clients and referral partners.

### **FORECLOSURE**

Foreclosure is the legal process in which a bank or other secured creditor either sells or repossesses a parcel of real property, home or land, after the owner has failed to comply with the mortgage or deed of trust agreement with the lender. Most frequently, the violation of the mortgage agreement is the default of payment. The completion of the foreclosure process allows the lender to sell the property, and keep the proceeds to pay off the mortgage as well as any legal costs. The length of the foreclosure process varies from state to state.

If the foreclosed property is sold for less than the remaining primary mortgage balance, and there is no insurance to cover the loss, the court overseeing the foreclosure process may enter a deficiency judgment against the borrower. Deficiency judgments can be used to place a lien on the borrower's other personal property, obligating the borrower to repay the difference or suffer the loss of their property. It gives the lender a legal right to collect the remainder of debt out of borrower's other existing assets.

However, there are exceptions to this rule. If the mortgage is classified as "non-recourse debt," then the borrower has no personal liability in the event of foreclosure. This is often the case with residential mortgages. If so, the lender may not go after borrower's personal assets to recoup additional loss.

The lender's ability to pursue a deficiency judgment can be restricted by state laws. In California and some other states, original mortgages (the ones taken out at the time of purchase) are typically non-recourse loans, however, refinanced loans and home equity lines of credit aren't.

If the lender chooses not to pursue a deficiency judgment-or can't because the mortgage is non-recourse-and writes off the loss, the borrower may have to pay income taxes on the un-repaid amount if it can be considered "forgiven debt."

Any other loans taken out against the property being foreclosed (second mortgages, HELOCs) are "wiped out" by foreclosure (in the sense that they are no longer attached to the property), but the borrower is still obligated to pay them off if they are not paid out of the foreclosure auction's proceeds.

### **How Does a Foreclosure Affect Credit?**

A foreclosure can be reported as a Foreclosure or Repossession and carries a derogatory payment status of 8 or 9 (M1, R1 and I1 being the best and R9, I9, etc. being the most negative) which is just under a Public Record. There is a misconception that foreclosures are considered Public Records to the scoring system, however, they are not. Although there is a Public Notice Record on file once a foreclosure is filed, but this record is completely different than a credit report public record.

A Foreclosure will remain on a credit report for 7 years from completion date. And the score will drop from 50-250 points. The difference in point loss depends on how many points your client has to lose in the payment history factor of their credit. So if someone has a 750 credit score, and they opt to foreclose, their score could drop up to 250 points. However, if someone has a 500 credit score, they may lose 50 points for the same derogatory.

If a Deficiency Judgment or Tax Lien is filed in connection with a Foreclosure, the credit score can drop an additional 100 points.

## Fannie Mae Waiting Period

The current [selling guideline](#) from Fannie Mae has upped the previous 4 year period of how much time must elapse after a foreclosure to 5 years from the date the foreclosure proceeding is completed, not started.

The exception for extenuating circumstances has been increased from a 2 year to a 3 year waiting period.

**WORD OF CAUTION:** If you have a borrower going through a foreclosure due to circumstances of losing a job, a medical crisis, sub-prime mortgage crisis fall-out, I suggest that you advise them to fully document their experience now. Not to wait until later, because the details and emotional energy of what they are going through will be more difficult to document and prove down the road if they decide to apply for a loan in 2 years based on an extenuating circumstance claim.

In General: When it comes to foreclosure and how it affects the ability to obtain credit in the future, there are multiple points of extremely negative impact. Deficiency judgments for the amount not collected by the lender in the foreclosure sale can end up on the borrower's credit report as a derogatory mark. Additionally, there is a high risk that the borrower will be hit with a substantial tax penalty which can result in a tax lien, which also appears on the credit report. As a general rule, other than a bankruptcy, foreclosure is the least desirable of all of the options available when a borrower is upside down in a home mortgage.

## Deed in Lieu Of Foreclosure

An alternative to foreclosure is a "deed in lieu of foreclosure." In this scenario, the borrower turns the house over to the lender and walks away without owing anything. A deed in lieu of foreclosure offers several advantages to both the borrower and the lender. The main advantage to the borrower is that it immediately releases him or her from most or all of the personal debt associated with the defaulted loan. The borrower also avoids a foreclosure proceeding and may receive more generous terms than he or she would in a formal foreclosure. Advantages to a lender include a reduction in the time and cost of repossessing the property.

However, the lender usually will not proceed with a deed in lieu of foreclosure if the outstanding debt on the property exceeds the current fair market value of the property. So in this market, this option probably won't be available to most homeowners who are upside down.

## How Does a Deed in Lieu Of Foreclosure Affect the Borrower's Credit?

Most lenders report a deed in lieu of foreclosure as a foreclosure, so the credit scores will carry the same serious affect as if it were an actual foreclosure. However, what most borrowers don't know is that they can negotiate with the lender to report it differently in return for turning over the deed and avoiding foreclosure costs.

Many lenders will say that they cannot change the reporting status, but they can. Here are their options in preferred order:

- Paid As Agreed - Credit scores will have already dropped over 100 points due to default in payments, however, if reported as Paid As Agreed, the borrower will be able to purchase another home in a shorter time period.
- Paid Settlement - Credit scores could drop up to 150 points.

The item will remain on the credit report for 7 years from the completion date or the settlement date.

## Fannie Mae Waiting Period

The [selling guideline](#) from Fannie Mae has not changed. It is a 4 year period of how much time must elapse after a deed in lieu of foreclosure proceeding is completed.

The exception for extenuating circumstances also remains the same at 2 years.

## Short Sale (aka Pre-Foreclosure Sale)

In my opinion, the best option is a short sale, which occurs when a bank or mortgage lender agrees to discount a loan balance, due to an economic hardship on the part of the home owner. The home owner sells the mortgaged property for

less than the outstanding balance of the loan, and turns over the proceeds of the sale to the lender in full satisfaction of the debt. In such instances, the lender would have the right to approve or disapprove a proposed sale.

A short sale is typically executed to prevent a home foreclosure. Lenders often choose to allow a short sale if they believe that it will result in a smaller financial loss than foreclosing. For the home owners, the advantages include avoidance of having foreclosures on their credit histories. Additionally, a short sale is typically faster and less expensive than a foreclosure.

Junior lien holders, such as holders of second mortgages, HELOC lenders, and homeowner associations (special assessment liens), may also need to approve the short sale. Frequent objectors to short sales include those who hold tax liens (income, estate or corporate franchise tax - as opposed to real property taxes, which have priority even unrecorded) and mechanic's lien holders. It is possible for junior lien holders to prevent the short sale.

While it is frequently common for a lender to forgive the balance of the loan in question, it is unlikely that a lien holder that is not a mortgagee will forgive any of their balance. Further, it is common for a lender to omit updating the zero balance and settlement option on the mortgagor's credit report, or even flat-out refuse to do so "due to their financial loss."

## **The Mortgage Forgiveness Debt Relief Act Of 2007**

When the lender decides to forgive all or a portion of the debt and accept less, the forgiven amount is considered as income for the borrower, like with a foreclosure, leaving it open to be taxed. However, The Mortgage Forgiveness Debt Relief Act of 2007 contains amendments to remove such tax liability, allowing the borrower and lender to work together to find a solution beneficial to both parties.

## **How Does a Short Sale Affect the Borrower's Credit?**

The few reported short sales that I have seen have appeared as "Paid Settlements" on a mortgage account. In the wake of the current mortgage crisis, short sales are becoming extremely common, but legislation has not caught up with the tidal wave and there is no law on the books relating to them to date. As a result, there is an opportunity for the borrower to negotiate credit reporting with the lender. I've seen several successful negotiations, so be sure to let your borrower know that it is possible.

My view - a short sale proves that the borrower is exhausting every effort to pay the loan. The borrower has willingly committed to taking on months of emotional and physical stress in a good-faith effort to sell the property to maintain a good relationship with that lender. Most likely, the reason they can't afford their current mortgage is because they were in an adjustable product and their mortgage payment has doubled. That doesn't mean that they can't afford a different loan program with a lower payment. Which leads me to wonder what the incentive is for lenders not to negotiate with the borrower on how the item is reported to the bureaus. All they would be doing is cutting off a pretty substantial future income stream if they put these types of borrowers out of the market for two years. In that light, negotiation for a non-report on short sales is well worth it.

Here are their options in preferred order:

- Paid As Agreed - Won't hurt the score at all as long as the borrower has kept payments current.  
Unrated - May drop a few points.
- Paid Settlement - Credit score will drop 50-150 points.

If reported, the item will remain on the credit report for 7 years from the completion date or the settlement date.

## **Fannie Mae Waiting Period**

A few weeks ago, Fannie Mae was going to consider a short sale the same as a foreclosure, however, the current [selling guideline](#) from Fannie Mae has reduced the amount of time that must elapse after a short sale to 2 years from the date the short sale is completed, not started.

There is no exception for extenuating circumstances.

## Bankruptcy Mortgage Relief

Currently, bankruptcy offers very limited protection to a homeowner who is upside down with their payments. The borrower can file a Chapter 7 which, depending on the state bankruptcy law, will most likely require him or her to surrender the property to the bankruptcy court, or file a Chapter 13 debt repayment plan to spread out prior delinquent payments over a number of months or years in the future. However, no bankruptcy proceeding can modify the terms of an existing home loan on a principal residence. Legislation is being proposed to Congress that would allow bankruptcy judges to modify the terms of an existing mortgage loan. I would not hold my breath. It could take years to make further substantial changes to the bankruptcy laws.

## How Does a Bankruptcy Affect the Borrower's Credit?

My advice on this is to avoid Bankruptcy at all costs unless, your borrower is upside down on everything. Not only have the new bankruptcy filing requirements become more difficult and more costly, a public record will wreak havoc on credit scores and could stop someone from being hired or renting a place to live.

A Chapter 7 Bankruptcy will remain on the report for 10 years, and a Chapter 13 will remain for 7. The point loss could be from 100-350 points, depending on how many points the borrower has to lose in this factor.

## Fannie Mae Waiting Period

The [selling guideline](#) from Fannie Mae has not changed. It is a 4 year period of how much time must elapse after a Chapter 7 Bankruptcy. The 4 year period can start on either the discharge or dismissal date.

The exception for extenuating circumstances is 2 years.

Again, the [selling guideline](#) from Fannie Mae has not changed. It is a 2 year period of how much time must elapse after a Chapter 13 Bankruptcy. The 2 year period can start on either the discharge or dismissal date.

In the case of multiple bankruptcies, the current [selling guidelines](#) that have just been added require a 5 year waiting period from the most recent discharge or dismissal date.

The exception for extenuating circumstances in the case of multiple bankruptcies is a 3 year waiting period from the most recent discharge or dismissal date.

## What's the Good News?

- **Aging Out:** In all instances above where I reference how many points will be lost in each scenario, it is important to make sure your clients understand that over time, all derogatory accounts age out. This means, the older the account becomes, the less it will hurt their credit scores.
- **7 Year Reporting Period:** The law states that derogatory items "can be" reported for 7-10 years as outlined above. It doesn't state that they "MUST BE." My experience proves over and over again that there is no need to wait out the 7 years. You don't have to. You can start seeking early removal of the item by disputing to the credit bureaus that are reporting it. In many instances, after 3-4 years, the item will be deleted.
- **You can Start Recovering and Rebuilding immediately.** This is key information because many consumers feel doomed for the next 10 years. They have no idea that they can start rebuilding their credit immediately. Put together a Recover and Rebuild kit for your clients. If you are too busy to create the kit, click here to read about CRC's Recover and Rebuild Section of our From Loan To Loan Content Site.

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