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# Are you an idiot to keep paying your mortgage?

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Should you keep paying your mortgage?

If you have significant equity in your home, absolutely.

If you don't, it's getting harder to answer that question, especially when our government keeps giving people who owe more than their homes are worth so many reasons not to pay.

Last week, the government announced a program that will substantially lower payments for many homeowners who have little or no equity, but only if they are at least 90 days delinquent.

Critics say the plan, which applies to loans owned or guaranteed by government wards Fannie Mae and Freddie Mac among others, could encourage people to suspend payments.

But what about the moral obligation to pay off a debt?

Elected officials have been chipping away at that by blaming the foreclosure crisis largely on predatory lenders. In a campaign fact sheet, President-elect Barack Obama says he "recognizes that the real victims in the subprime mortgage crisis are not the lenders, but the millions of borrowers who followed the rules and whose only crime was taking out mortgages that lenders told them they could afford."

Last year, Congress started removing some financial hazards of default when it passed a bill that temporarily waives the income tax on mortgage debt that is canceled when a homeowner is foreclosed upon, sells a home for less than the remaining debt (a short sale) or gets a loan modification that reduces the principal balance.

The tax waiver originally applied only to debt on a primary residence canceled in 2007, 2008 or 2009. Last month, in the bailout bill, Congress extended the waiver until 2013.

There are exceptions: The waiver applies only to debt that was used to buy or improve a primary residence. If you took out a home-equity loan or did a cash-out refinance to buy a car, you'll still owe tax on that debt if it is canceled. For state income taxes, California has partially conformed to the federal law, but only for debt canceled in 2007 or 2008. (For more details, see my April 24 column at *www.sfgate.com/ZFJS*.)

The Federal Housing Administration is offering two programs to help homeowners get more-affordable mortgages, FHA Secure and Help for Homeowners. Neither requires borrowers to be current on their payments.

The program announced Monday goes a step further by requiring homeowners to be late.

The Streamlined Modification Program, sponsored by the government agency that oversees Fannie Mae, Freddie Mac and 27 loan servicers, promises to swiftly reduce payments for certain homeowners who appear to be on the verge of foreclosure.

**How to qualify**

To qualify, you must be at least 90 days delinquent and live in the home as your primary residence. You must owe at least 90 percent of the home's value. It's fine if you owe more than it's worth.

Your mortgage must be owned or guaranteed by Fannie Mae and Freddie Mac or held by one of the participating loan companies.

If you meet these requirements and can document your income, your servicer will reduce your monthly mortgage payment - including property taxes, insurance and association dues - to 38 percent of your gross income.

The reduction can be accomplished in one or more ways:

-- Reducing the interest rate, but not below 3 percent. (The new rate, if below market, goes back to a market rate after five years.)

-- Extending the term of the loan up to 40 years.

-- Reducing the principal on which monthly payments are calculated. Unpaid principal is added to the loan balance and due when the homeowner sells or refinances. The reduced interest payments never have to be repaid.

If you owe more than the home is worth, the plan will only reduce principal down to 100 percent of market value, according to an official for the Federal Housing Finance Agency, which supervises Fannie Mae and Freddie Mac.

If all three of these maneuvers can't reduce your payments to 38 percent of income, you won't get a fast-track modification but could still request a customized deal, says the official, who spoke on the condition of anonymity.

The streamlined process looks only at income, not assets. If you refinanced your home to buy a Mercedes or own another home, you won't be expected to sell them to pay your mortgage.

Peter Schiff, president of Euro Pacific Capital, predicts that many homeowners who have little or no equity will stop paying their mortgage and then reduce their income to get the biggest payment cut possible. They could stop working overtime or, if two spouses work, one could quit. After the modification, they could try to boost their income again.

"This is a once-in-a-lifetime opportunity," Schiff says. "People are going to feel like complete morons if they don't participate. The people getting punished are the ones who never made an irresponsible decision to buy a house they couldn't afford."

The government is offering loan servicers $800 for every homeowner they get into the plan.

Schiff predicts that loan agents "will be cold-calling people trying to get them into it. Just like they encouraged people to overstate their income to get a bigger loan in the first place, now they will encourage them to understate their income to qualify for a smaller loan."

To prevent fraud, the government says a borrower "must certify that he or she experienced a hardship or change in financial circumstances, and did not purposely default to obtain a modification."

The housing agency official doubts that people will stop paying just to get a modification because it will hurt their credit record, and that will make it harder to get a loan and possibly a job.

"Credit bureau reports are checked by employers. They're taking a big risk missing three payments just to get a lower rate," she says. An existing lender who sees your credit score deteriorate could also cut back on your credit and possibly raise your rate.

**Credit score impact**

Risking your credit score for a lower rate "sounds like a game of chicken on the lending highway," says Craig Watts, a spokesman for Fair Isaac, which markets the FICO credit score.

A 90-day delinquency will hurt your score, but not as badly as a foreclosure. How many points it takes off depends on other things in your credit file, such as the number and severity of late payments on other accounts.

In the latest version of FICO, which is just being rolled out, "one isolated delinquency will do less damage to your score than it has in the past," Watts says.

Consumers who suffer a severe delinquency can rebuild their scores over time by paying all credit accounts on time and keeping their balances low.

"If it was me and I was certain that I could keep my home even after missing a couple payments by working out a deal with the lender, I'd be for keeping the home," Watts says. "Your score will bounce back."

Schiff predicts that many homeowners will reach that conclusion and that the new program will cost Fannie and Freddie far more than expected.

Although the mortgage giants are under a government conservatorship, the housing agency official says that any losses under the program will not be paid for by taxpayers unless Fannie and Freddie exhaust their reserves.

Net Worth runs Tuesdays, Thursdays and Sundays. E-mail Kathleen Pender at kpender@sfchronicle.com.

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