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COMMENTARY

Short Sales Offer Advantages for Lenders, Troubled Borrowers

By Sushil K. Tuli

THOUSANDS OF PEOPLE WITH THE PROSPECT OF foreclosure hanging over their heads may have another way out of their dilemma that will leave their credit and finances largely intact. A transaction known as a "short sale" might sound too good to be true, but for many people it is the best possible option to get out from under the weight of an unaffordable mortgage.

In Massachusetts, foreclosure rates continue to break records due, in part, to subprime lending practices. There were 2,185 petitions to foreclose filed in Massachusetts Land Court in July, up 66.5 percent from the 1,312 filed in July 2006. During the first seven months of 2007, 15,130 foreclosure petitions have been filed, an increase of 66.5 percent compared to the 9,089 filed at the same time last year, according to The Warren Group, Banker & Tradesman's parent company.

The prospect of foreclosure places homeowners in a no-win position. Not only does foreclosure cause a significant decrease in credit scoring, but embarrassment and shame, as well.

Typically, when a property owner fails to make mortgage payments for a number of months, they are in default. The first step of the foreclosure process, which usually takes a number of months, involves filing notice of the default. In a short sale, after a public document is recorded, the property owner will contract to sell the home with the condition that the lender has agreed to accept a lesser amount than what is owed on the mortgage.

A growing number of lenders are approving short sales as an alternative to foreclosure. Doing so allows them to avoid having to take over and manage property. From the lender's perspective, a short sale saves many of the costs associated with the foreclosure process, including attorney's fees, eviction process, delays from borrower bankruptcy, property damage and costs associated with resale. In a short-sale scenario, the lender gets the property back faster, so it is able to cut its losses. A short sale is a win for the homeowner in many respects, as well.

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Though short sales place additional downward pressure on the national median home price, Fannie Mae Chief Economist Dave Berson says they also lower the number of foreclosures and can help ease the housing downturn. Short sales are hard to track, however, because they are not counted, making it impossible to know exactly how many occur. What is known is that with more people taking out adjustable loans, many real estate markets in decline and 100 percent financing more difficult to obtain, the number of short sales is increasing.

The short-sale pathway is easily navigated by following the necessary steps. First, a homeowner will need to verify the value of the property. If a real estate broker is handling the sale of the property, he or she must provide an estimate of market value. If the property is being sold privately, the homeowner will need to handle the market analysis of the area and property.

Next, all costs of selling the property must be totaled. A real estate broker will provide an estimate of closing costs. If a property is being sold by the homeowner, a local title company or real estate attorney can provide an estimate on closing costs.

The third step requires that a homeowner determine the total amount owed against the property, including home equity loans and equity lines of credit. The total amount owned against a property is then subtracted from the estimated proceeds of the sale. On a short sale, this will be a negative number. After establishing the amount, the homeowner or real estate broker contacts the lender and asks the head of the mortgage department what its procedures are for a short sale. Each lender has a different policy. Some lenders are willing to work with a homeowner by reducing the amount owed or making other arrangements. Other lenders will look to the agents involved or anyone else who is making money off the transaction to see if they are willing to make concessions so that the transaction happens. Some lenders will not want to talk about a short sale at all.

Pros and Cons

There are pros and cons to be considered when thinking about a short-sale.

One benefit to homeowners is that they will walk away with a little money in their pockets to get back on their feet. If they have worked with the right short-sale agent, they

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will have avoided the serious "foreclosure" or "paid less than agrees" black mark on their credit report that can have a negative effect for up to 10 years. In addition, an experienced short-sale agent will have assisted the homeowner in avoiding a deficiency judgment on their credit for the amount of money the lender lost from selling the home for less than was owed.

One of the major drawbacks to a short sale is that the Internal Revenue Service will consider the lesser amount received by the lender as taxable "debt relief" income to the seller. The IRS reasons that because a homeowner is not required to pay the loss the lender incurred, it is the same as receiving income and therefore taxable.

A short sale may still be an emotional time for a seller forced to give up a home they have worked hard to buy and maintain, but in almost all respects is it preferable to foreclosure.

There are pros and cons for buyers of short-sale homes, as well. Most of the time, a buyer of a short-sale property is able to purchase a property at 10 percent to 30 percent below market value. The buyer moves in with instant equity, which acts as a buffer, even if the market goes into decline over the following months. Also, a short-sale buyer often must be willing to wait to know if their offer has been accepted. The process can take from four weeks to four months. This can be a serious problem for some people, but those who can wait usually come out ahead.

In spite of the pros and cons, short sales can be win-win situations for all concerned, whether seller, buyer or lender.

There are issues to be aware of before moving forward with a short sale. For instance, closing costs will include title and escrow fees, attorney fees, a portion of unpaid property taxes, re-conveyance fees, notary fees, delivery fees, documentary fees and/or transfer fees.

A homeowner considering a short sale of their property without the assistance of a real estate broker will save the amount of the commission and have more to apply toward paying off the loan. Also, a homeowner who feels more secure having a real estate broker handle the transaction might want to enlist the services of a discount broker to market the property or try to negotiate the sales commission with a broker.

If a property is transferred under a short sale, the lender may require the buyer to make up the difference between sale price and the existing mortgage, either through a personal obligation or a collection.

The IRS often gets involved with short sales because they are seen as a relief of debt and may be treated as income. A reputable accountant can provide advice in this area. ■