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DON'T SELL SHORT SALES SHORT

By James P. Gaines

As many as 25 percent of homeowners nationally owe more on their mortgages than what their property is worth. The Mortgage Bankers Association reports that approximately 4.2 million homeowners missed at least one month's payment during the second quarter of 2010, and more than two million were in foreclosure by the end of the quarter. Between four and five million mortgages are in difficulty, with the prospect of foreclosure filings reaching three million in 2010.

RealtyTrac reported that foreclosures accounted for 31 percent of all sales in the United States during first quarter 2010. Similarly, the National Association of Realtors (NAR) estimated about one-third of all reported home sales fell into this category. With total annual home sales around 5.5 million units, this means approximately 1.8 million are distressed.

Short sales are a growing trend among lenders and homeowners seeking to avoid foreclosure. In a short sale, the lender agrees to accept the sale's net proceeds as complete payment for the existing debt, even if it is "short" of the full amount. NAR estimated that for the 12-month period through April 2010 about 12 percent of existing home sales, or almost 622,000 houses, were short sales. NAR's data indicate that since October 2008 short sales consistently accounted for 10 to 15 percent of total reported sales (see figure).

During the current housing slump, the federal government interjected significant, multiple stimulus efforts to try to establish stability. The Making Home Affordable Program includes the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP) for loans owned or guaranteed by Freddie Mac or Fannie Mae. The objective of both programs was to reduce the borrower's monthly payments to avoid foreclosure by refinancing the loan or modifying the loan terms. To date, these programs have helped a relatively small fraction of targeted borrowers.

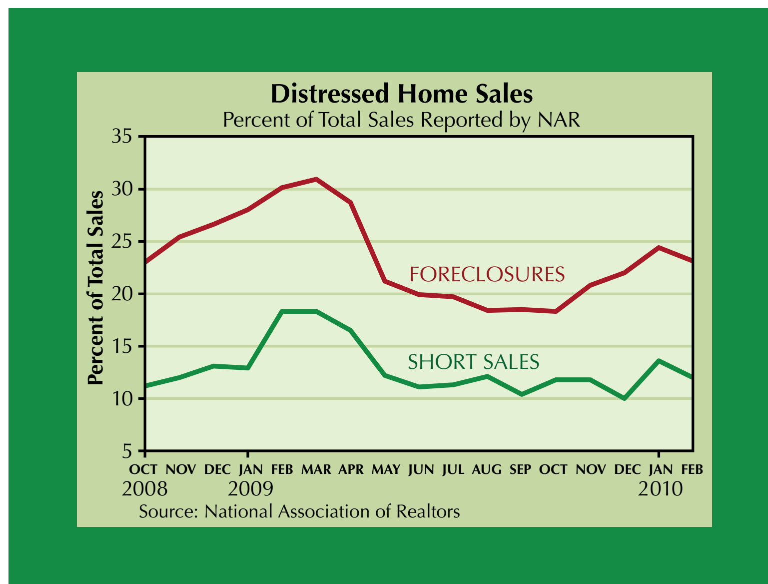
In April 2010, the Treasury Department initiated the Home Affordable Foreclosure Alternatives (HAFA) program for HAMP-eligible homeowners who seek a short sale or deed in lieu of foreclosure alternative solution with their lender. HAFA provides servicers, sellers and junior lien holders incentives for short sales or deeds in lieu of foreclosure and simplifies and streamlines the formerly unorganized process.

HAFA uses borrower financial and hardship information collected for HAMP to give borrowers preapproved short sale terms, including the minimum acceptable net price, before listing the properties for sale. The program requires that borrowers be fully released from future liability for the first mortgage and provides standard procedures, processes, documents and deadlines.

Fannie Mae and Freddie Mac released their guidelines for HAFA short sales on June 1 for the program to be completely operational by August 1. Incentives include $3,000 for borrower relocation assistance, $1,500 for servicers for administrative costs, and up to $2,000 for investors who allow up to $6,000 in short sale proceeds to be distributed to subordinate lien holders.

Current market conditions and HAFA have led many mortgage holders to conclude that they may be financially better off agreeing to a short sale rather than pursuing a costly and time-consuming foreclosure.

Distressed sales (foreclosures and short sales) during the past three years dominate many markets (see figure). Posted foreclosure sales totaled more than 720,000 during the first half of 2010. The magnitude of short sales activity remains somewhat obscured by the fact that most sellers do not want to market their properties as short sales for fear of not getting the top price.



Source: National Association of Realtors

The Federal Housing Finance Agency's *First Quarter 2010 Foreclosure Prevention & Refinance Report* indicated that Fannie and Freddie, even before implementing the HAFA program, completed 23,379 short sales during first quarter 2010 and 19,102 in fourth quarter 2009 compared with 8,050 in first quarter 2009 and only 1,776 in first quarter 2008.

Real estate agents in many areas specialize in short sales and foreclosure sales. Some carry specialty designations such as Short Sales and Foreclosure Resource (SFR) Certification offered by NAR or Certified Distressed Property Expert (CDPE).

Short Sale Basics

A short sale, also known as a preforeclosure sale, is a transaction in which the lender (or lenders) agrees to accept the proceeds of the sale in lieu of the total debt owed by the current homeowner. By definition, the net sale price in a short sale will be less than the total debt balance and the lender(s) may or may not forgive the difference. The current owner/seller receives none of the proceeds of a short sale, which go entirely to pay off the debt(s) on the property. Owners may favor a short sale rather than a foreclosure because of the potentially reduced impact on their credit ratings and their personal financial conditions. A short sale can be initiated even after posting of a Notice of Trustee Sale but before the actual foreclosure sale.

Short sales are a viable option when the current homeowner cannot qualify for a loan modification or refinance, if the property will not sell for enough to cover the existing loan and if there are no other prospects to pay the mortgage. In such cases, foreclosure is highly probable or imminent.

A "strategic" short sale, that is, if the owner has the capacity to make the mortgage payments but chooses not to because the loan is greater than the current value, is not really an option. The lender would expect the borrower to keep the loan current and would pursue a deficiency if the borrower did not.

Getting a lender to approve a short sale is primarily a matter of economics. Lenders increasingly favor short sales to avoid the more costly and time-consuming process of foreclosure and sale. One survey found that short sales may reduce loss severity by 13 percent, and in states where the foreclosure process is particularly lengthy, losses may be as much as 26 percent less.

For the past couple of years, lenders have hesitated to pursue many troubled home loans and underwater borrowers, thus prolonging the soft housing market and further eroding property values. The lenders simply could not afford the losses or lacked sufficient administrative capacity to process the volume of problem loans. The government provided numerous forbearance options, from mark-to-market accounting changes to foreclosure moratoriums and loan modification programs, to help forestall the swell of home evictions.

But many lenders, especially the larger banks and Freddie and Fannie, now recognize that loan modifications and refinancings are not going to solve the majority of problem home loans. Alternative exit strategies are needed.

Fueled by the severity of the housing bust, HAFA and general market acceptance, there is a growing movement toward proactive short selling rather than the reactive approach most lenders historically followed. Lenders are much more receptive to a cooperative approach involving the homeowner, the loan servicers and the real estate agent moving the property through the process as quickly and profitably as possible. Lender acceptance of short sales is greater in judicial foreclosure states with lengthier, more costly foreclosure processes than in nonjudicial foreclosure states, like Texas, where foreclosures are less time consuming and less costly.

Every short sale differs depending on the local market, the lender, the property, the seller, the buyer and the degree of presale work done. Sellers benefit from engaging an experienced real estate agent to assist them through the process. Doing so avoids costly delays and mistakes. Agents with prior short selling experience know what lenders are looking for, how to collect the necessary documentation and data, and who to approach to get the sale accepted. The seller may also seek out specific legal and tax advice for protection, as the consequences of a short sale can be complicated.

Qualifying Steps

Not all sellers will qualify and receive lender approval for a short sale, and not all lenders will accept a short sale or discounted payoff if and when it is offered. A homeowner considering a short sale should contact the loan servicer or lender to

preapprove the arrangement, including setting the minimum acceptable price and any other terms rather than first obtaining an offer and then trying to get it accepted.

Qualifying for a short sale typically requires that all of the following conditions exist:

- *The home's current market value is less than the debt.* If this were not the case, the lender would favor foreclosing and selling for a greater price. This step requires recent market data and comparable sales to substantiate the expected sale price. It may be expeditious to indicate that the net proceeds from a short sale are expected to exceed those of a foreclosure sale.
- *The mortgage is in or near default.* Historically, lenders would not even consider a short sale unless the loan was substantially delinquent and in default. In today's economic conditions, some lenders will approve a short sale for a property that is current but in imminent danger of defaulting.
- *The seller has a true hardship with little hope of bringing or keeping the loan current or of being able to make up any deficiency between the net sale price and the amount of the debt.* Examples of hardship include loss of job or income, divorce, medical costs, emergencies or sudden debilitating illness, bankruptcy, and death. The seller's wish to get out from under the loan is not enough.
- *The seller has no other assets with which to pay back all or part of the debt.* The borrower generally provides a full financial statement, balance sheet, tax returns and bank statements to document the absence of other financial resources.
- *The borrower is unable to qualify to modify or refinance the loan.* Most lenders would rather modify or refinance a loan so the owner can afford the monthly payments and remain in the home rather than having to settle for repayment of less than the full loan amount. The HAMP and HARP programs were initiated for this very purpose.

Once the seller has qualified, a short sale typically proceeds like any other sale except that the lender, not the seller, controls decisions. The property is marketed and offers to buy the property are obtained. The seller forwards each purchase offer to the lender, who accepts the best offer. The deal closes, and the lender receives the net proceeds.

Complications of Short Sales

While these steps seem simple, the timing, corporate bureaucracy integral to lenders and servicers, and the degree of documentation required often cause the short sale process to take weeks or even months longer than a typical sale. Today, most lenders are overwhelmed by the volume of problem loans, foreclosures, workouts, and modification requests as well as short sales. Many simply lack sufficient staff with experience, training or the capacity to make timely decisions. Even after receiving a valid sales contract, it may take anywhere from 30 to 120 days or more to get final approval from a lender.

Owners may favor a short sale rather than a foreclosure because of the potentially reduced impact on their credit ratings and personal financial conditions.

The lender controls contract acceptance as well as the sale's terms and conditions. Lenders may consent to a short sale but then refuse an offer as insufficient if they disapprove of the price. Even if an offer is accepted, the purchase contract may specify that the property may continue to be marketed prior to closing to obtain other offers.

All short sale contracts include a contingency whereby the lender must approve all aspects of the sale. For example, while a buyer will want to have the property inspected for physical condition of the operating systems (heating, air conditioning, sprinkler system), neither the lender nor the seller have any incentive to repair or fix any defects found. Therefore, most short sales are "as is." Lenders can accept any offer at any time

for a higher price. If a prospective buyer has spent any money based on the original acceptance — for property inspection fees, for example — the buyer may discover their deal has been rescinded with no recourse to recoup the money spent.

Lenders may reject a short sale request for any number of reasons, but the most common are:

- *Price is too low.* The lender will always request either a full appraisal or at least a broker's price opinion much the same as if it were making a new loan on the property. If the lender believes it can make more money by selling the property through foreclosing, it will reject the short sale contract.
- *Short sale documentation package is incomplete, deficient or lost.* The paperwork for the short sale is every bit as demanding as for a new loan request and sometimes even more so. One of the most common delays comes from the lender losing, misplacing or never receiving a document(s) that causes delay or even refusal.
- *Seller does not qualify.* While it is advisable to get preapproved for a short sale, some sellers wait until after procuring a potential buyer or listing the property with a broker. Some lenders do not want to preapprove and prefer to wait and examine a specific deal. Either way, the seller will need to meet the qualifying criteria.
- *Buyer does not qualify.* As is the case in underwriting a new mortgage loan, the lender wants to make sure the buyer is going to be able to close the deal if approved. A loan prequalification letter or preapproved home loan from the buyer's lender may be required to satisfy the seller's lender.
- *Lender no longer owns the loan.* Sometimes, banks and other lending companies may not realize that they no longer own the loan, even though they may still be servicing it. If they are not the owner, they may lack the authority to approve the sale. This particular problem can be avoided early on by requesting the title company to check for an assignment of deed of trust or other documents reflecting ownership of the loan.
- *Junior lien holder refuses to accept the sale.* More than one loan on a property will complicate the process unless there is complete agreement and cooperation between the first lender and the second. In many cases, the short sale will not cover the total debt in the first mortgage, much less encompass all of the debt secured by the home. Second lenders may require a minimum percentage of the sale price, a new promissory note from the seller or some other inducement to release their liens on the property.

As with any real estate transaction, the best action any party can undertake is to read and understand the entire agreement. For a short sale, buyers and sellers and real estate agents should be knowledgeable about all of the various clauses in the listing and purchase agreements, as they may differ from a normal sale transaction.

Buyer's Perspective

Buyers generally expect to acquire foreclosures or short sale properties for a substantial discount over current market price. RealtyTrac's first quarter 2010 report stated that the average price discount of a home in foreclosure was 27 percent, the average discount of an REO ("real estate owned," a home taken back by the lender) was 34 percent and the average discount of a preforeclosure sale (typically a short sale) was 15 percent.

For some buyers, transaction time alone for short sales may warrant a substantially discounted offer. The lender may wait for additional offers, selecting the highest bid price even if it was submitted later than another prospective buyer.

Buyers and their real estate agents can conduct some preliminary research to make the process easier.

First, find out if the property has been preapproved for a short sale or if the seller is initiating the qualification process based on the purchase agreement. Find out as much as possible

about the seller's short sale status with the lender, who the lender is, and if there is more than one mortgage on the property. Buyers may even consider submitting a copy of the purchase agreement and earnest money deposit to the lender directly.

If there is more than one loan, does the junior lien holder have the authority to hold up or stop the transaction? Do the lenders have an agreement as to how the short sale is going to be handled?

If possible, buyers should examine local area comparable sales data to estimate current prices, including foreclosure sales and other short sales. The lender will have this information and use it to make its acceptance decision. Buyers looking for exceptional discounts may be disappointed.

Short sale properties are sold "as is" upon closing, which may be several months in the future. So most if not all repairs are the buyer's responsibility. This should be factored into the offering price.

Real estate commissions are paid to the listing agent by the lender accepting a short sale, not the seller/owner. Both Fannie Mae and Freddie Mac have policies that their servicers are not allowed to renegotiate short sale commissions below the amount agreed to by the real estate broker and the seller/owner, but commissions are limited to no more than 6 percent. Private mortgage insurance companies, second lien holders or short sales for loans not involving Fannie or Freddie may seek to reduce commissions. A buyer's agent should communicate with the listing agent.

Short sales are a viable option when the current homeowner cannot qualify for a loan modification or refinance, if the property will not sell for enough to cover the existing loan and if there are no other prospects to pay the mortgage.

Seller's Perspective

Short sales are generally the "next-to-last" option owners and lenders have before foreclosure. From the seller's standpoint, the short sale offers a way to get out from under the loan and start over. Sellers generally expect short sales to have a much less dire effect on their credit rating than a full foreclosure action, but that may not always be the case. The effect depends a great deal on whether the loan was delinquent, and by how long, before the short sale, how the lender reports the whole process to the credit rating agencies, and whether or not the owner defaults on other credit obligations. Ideally, the seller is not subject to a deficiency judgment, but that is at the discretion of the lender(s).

Fair Isaac and Company (FICO) officials state that common alternatives to foreclosure, such as short sales and deeds in lieu of foreclosure, represent "not paid as agreed" accounts, and are considered the same as foreclosures in computing a FICO score. Any of these options, however, are better than a bankruptcy, which has a greater negative impact.

While the effect of a short sale remains on the credit report for seven years, the impact on scores can begin to diminish after just a couple of years as long as it remains the only blemish (see http://www.myfico.com/crediteducation/creditscores.aspx). Fannie Mae and Freddie Mac recently issued statements saying short-sale sellers could be eligible for new loans backed by either agency within two years rather than having to wait seven years after a foreclosure.

Historically, a debt forgiven for less than the full amount would produce taxable income for the borrower. However, many debt deficiencies currently are exempt from federal taxes under the Mortgage Forgiveness Debt Relief Act of 2007. In general, if the home is the borrower's principal residence, the amount of difference between the price and the amount owed is not taxable. However, unpaid junior liens may be a different story. Sellers need to consult with a tax advisor to understand all tax effects.

'Flopping' Fraud

As with most normal market functions, some people try to find questionable, if not outright illegal, shortcuts. The FBI, Freddie Mac and Fannie Mae are reporting a short-sale scam called "flopping," a version of the more traditional home "flipping." The scheme generally involves a homebuyer convincing a lender to accept a short sale at a price less than a property's current market value. Meanwhile, he or she has another buyer lined up and quickly resells the property for a higher price.

The practice appears to be most prevalent in markets experiencing the widest swings in value. The scam, like many others, relies on manipulating or influencing the appraisals and value estimates the lenders rely on.

Technically, buying a property at short sale and reselling it for a profit is not fraudulent or illegal if the original short sale is conducted as a fair, arm's length transaction with no hidden buyer-seller relationships, unrevealed agreements to resell the property, or any undue influence on the appraisal. Some lenders now require more disclosure by sellers and buyers about any mutual relationships, prior agreements, and existing agreements with other third parties. Lenders are also wary of broker's price opinions and may require a full appraisal instead. Some lenders may even include a prohibition on reselling the property within a specified time interval.

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THE TAKEAWAY

In a short sale, the property is sold for less than the debt owed on it. The lender accepts the net sale proceeds as payment in full. Short sales may be less costly for lenders, and therefore are seen as a viable option in deteriorating markets where the current borrower has no other prospects to cover the loan amount. Short sales are more complex and time consuming than normal sales.

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