

Short Sales and Foreclosures: What Sellers and Borrowers Need to Know

What is a short sale or foreclosure? Is it better, in terms of credit, to go through one versus the other? What is going to happen to my credit if I go through a short sale or foreclosure? Right now, hundreds of thousands of families that can't make their mortgage payments are asking these questions. They are trying to figure out the most effective way to sell or walk away from their homes without devastating their credit scores or making it near impossible to buy a home in the future. To make matters worse, a great deal of confusion exists about what a short sale or a foreclosure is, what they mean, and how they will affect someone's credit in the short and long term.

A short sale occurs when a bank or mortgage lender agrees to discount a loan balance, due to an economic hardship on the residence owner. Jeff Ragan of Ming Tree GMAC Real Estate in Eureka best explains it as "The owner sells the property "short" of what he or she owes on the house." The home owner may be responsible for the sale of the home, but the bank must approve any purchase offers put on the table. All sale proceeds are then turned over to the bank at close of escrow, and the debt is considered satisfied, unless stated otherwise in the contract. Read your contracts carefully and consult legal counsel. Lenders will often choose to allow a short sale if they believe that it will result in a smaller financial loss than foreclosing.

How does a short sale affect your credit? According to the Mortgage Relief Act of 2007 "The borrower and the lender can work freely together to find a common solution that is beneficial to all parties". The consumer can negotiate with the lender to NOT report the item to the credit bureaus. If the lender will not agree, the borrower can insist that a "paid as agreed" statement is placed on the report. This term will not affect your credit score. If adding this statement is not agreeable to the bank, a "paid settlement" will appear on your credit report. This will cost you 50-100 points, but it is easier to recover from than a foreclosure. Agreements like this must be done at the beginning of the process, put in writing, and signed by all parties.

How long would it be before you could purchase another home after a short sale? That depends on how it is reported to the credit bureau. Recent Fannie Mae and Freddie Mac guidelines state that a short sale is treated the same as a foreclosure. This company will not purchase the loan if the current borrower has had a short sale in the last 2-5 years. Negotiating with your lender on if or how they will report the sale to the credit bureaus is vital.

A foreclosure is the legal process in which a lender repossesses a property after the owner has failed to comply with the mortgage agreement and is in default of payment. The foreclosure legally allows the bank to sell the property and keep the proceeds to pay off the debt and the legal costs. If the property is sold for less than the mortgage balance, and there is no insurance to cover the loss, the court overseeing the process can place a lien on the borrower's other personal property. The lender has the legal right to collect the remainder of the debt out of the 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 California, the original mortgage— the debt taken out at time of purchase— is typically a “non-recourse” loan. This does not include refinanced loans or equity lines of credit. Any other loans taken out against the property are “wiped out” by the foreclosure. This means that they are no longer attached to the property, but the borrower is still obligated to pay those monies off, if the amounts are not paid out of the foreclosure proceeds.

How does a foreclosure affect your credit score? A foreclosure will drop your credit score immediately by 100-250 points. It is treated in a similar way to a bankruptcy and considered a serious, derogatory mark on a person’s credit. The borrower’s credit score is not only affected, but he may lose some of his current credit lines as well. And, of course, his chances of obtaining credit in the future are dim for quite a lengthy period of time.

How long will it be before you can purchase another home after a foreclosure? A lender will not give a home loan to any consumer who has had a foreclosure in the last 2-5 years. The actual amount of time before a borrower can qualify for a new loan depends on the specific circumstances that caused the foreclosure. Job loss, financial crisis, or medical crises are factors that are considered. 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 that can result in a tax lien. A tax lien will also appear on the borrower’s credit report. These issues can impede the future purchase of a home until the monies are paid and sufficient time has passed.

Hundreds of thousands of homeowners are considering a short sale or foreclosure to end their financial woes and want to know which option is going to be the least damaging to their credit. My advice to any homeowner on the verge of foreclosure is to find out what options are available. Do the research, consult the experts, gather as much information as possible, and weigh the pros and cons of each. Make an educated decision, because what may seem to be the best answer right now could have a serious impact on your life for years to come. If a short sale or foreclosure is the right option for you – do not despair. You can protect your credit by negotiating with your lender before the process begins and begin repairing your credit immediately.

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