



The Basics

How to buy from sinking homeowners

Today's tough market is encouraging more short sales, in which sellers avoid foreclosure and lenders OK reduced mortgage payoffs. For buyers, there are both deals and pitfalls.

By Bankrate.com

There are few active buyers in the real-estate market these days, but every one of them seems to be looking to buy a foreclosure or a short sale.

Foreclosure is a fairly well-understood process, but as "short-sale" signs sprout like weeds, you may wonder what they're all about.

When a lender agrees to accept a mortgage payoff amount less than what is owed in order to facilitate a sale of the property by a financially distressed owner, it's called a short sale. The lender forgives the remaining balance of the loan.

Everyone loses -- a little

Short sales are a mixed bag for the buyer, the seller and the lender.

If you're a seller, a short sale is likely to damage your credit, but not as badly as a foreclosure. You'll also walk away from your home without a penny from the deal, possibly making it difficult for you to find another place to live.

The buyer will get the property at a reduced price, but in all likelihood it will have its share of problems (think fixer-upper), and the new owner will need to go through considerable red tape to make the deal happen.

The lender will take a financial loss but perhaps not as large as it would have if it had foreclosed on the property. Further, there are two situations in which an attempt at a short sale is almost certain to fail:

No default on loan. Lenders almost never will accept short-sale offers or requests for short sales until the borrower is far behind in payments and a notice of default has been issued.

Bankruptcy. If the seller has filed for bankruptcy, forget it. Few, if any, lenders will consider a short sale when the seller has filed for bankruptcy because negotiating a short sale is considered a collection activity, and collection activities are prohibited in bankruptcies.

Can it work for you?

Buying a home in a short sale can be a hassle, so why should you consider it? Mainly, it boils down to the bottom line. You can get the property for a substantial discount. Because the lender is eager to get back as much of the money it lent out as it can, you may also get favorable financing terms.

Because sellers play an active role in the short-sale process, you will have their cooperation (and most likely won't need to evict them upon taking possession of the home). This is not always the case with a property that has gone through foreclosure.

[Use a short sale to escape foreclosure](#)

You may have become aware of the distressed situation on a property through an agent, a for-sale-by-owner ad or word of mouth, but this is not a do-it-yourself project. A short sale is one real-estate deal where you really need help from an experienced agent or attorney. Not all real-estate agents know how to handle a short sale, so make sure you consult with one who can demonstrate special training or a good track record with short sales.

Why lenders (might) agree

It might seem counterintuitive for a lender to go along with a short sale. After all, a lender is legally entitled to pursue the full balance of the loan. When a homeowner falls behind on payments, the lender can (and often does) hold the borrower responsible for every penny owed.

And yet more and more lenders are willing to consider approving short sales. In a January survey of senior loan officers conducted by the Federal Reserve Board, more than 65% of those surveyed said they anticipated short sales to be among significant loss-mitigation steps for 2008.

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Lenders are painfully aware of just how bad the foreclosure crisis is. They know the cold reality is that a large number of struggling borrowers will end up losing their homes and often see the sense in accepting the inevitable and trying to minimize their losses. Yet some lenders seem to remain in denial.

"Some of them are being tougher right now than they have a right to be," says Richard Geller of [MortgageReliefFormula.com](#). "I wonder if they expect a big bailout somehow. I expect lenders to get a lot more desperate later in 2008."

Foreclosure is an expensive and time-consuming process for a lender. By agreeing to a short sale, the lender wraps up its little mess quickly and perhaps with a smaller loss than in a foreclosure.

Remember that after foreclosing the lender owns the home and has to maintain it, insure it and pay taxes on it. So instead of receiving payments each month, the lender is now forking out money every month. Plus, short sales help the lender look good on paper -- the property never gets listed as an actual foreclosure, which helps the lender's numbers. Lenders often see short sales as the lesser of two evils -- if the numbers make sense for them.

[Continued: Identify potential short sales](#)

10 steps to follow

1. Identify potential short sales.

Locate properties in your area in danger of foreclosure. You can use an online database, search courthouse listings and legal ads or tap an experienced real-estate agent as a buyer's agent.

First, try to determine how much is owed on the house in relation to its approximate value. If the amount owed seems high, the property is a good candidate because it indicates that the seller might have trouble selling it for enough to satisfy the loan. Pass on those in which the owner has a lot of equity in the home; the lender likely would prefer to foreclose and resell nearer the market price.

2. View the property.

Gauge its condition and come up with a rough estimate of how much it's going to take to repair or renovate. If it needs work, many "normal" buyers won't consider it, which is good for you.

3. Do your research.

What is the property worth? What's the profit potential? If you're an investor or even a homeowner planning to live in the home a short time, you'll want to profit from the deal.

4. Find all liens and mortgages.

Ask the seller or his agent what liens are on the property and which lender is the primary lien holder.

5. Figure out the financing.

This is critical. You have to know how you're going to pay for the property. If you're a good credit risk, the existing lender may be willing to give you a loan. Because the lender already may have a lot of your information in the short-sale paperwork, it may be able to expedite the loan application process.

It's important to understand that in a short sale you have to have the ability to move quickly. Once an agreement is worked out, it is common for the lender to require closing in as few as 20 days. That's too late to start shopping for a mortgage.

6. Contact the lender.

You or your agent should speak with the loss-mitigation department (or perhaps the resource-recovery department) rather than the collection or customer-service department, which is interested only in recouping past-due loan payments.

Finding the decision maker can be one of the biggest initial challenges. You will first need to have the homeowner complete and sign (notarization is usually required) an authorization letter, which gives the lender permission to discuss the mortgage situation with you.

7. Complete the lender's short-sale application, if there is one.

Many lenders have an application specifically for a short-sale request. **8. Assemble the proposal.**

The proposal generally consists of a package of materials, including the application and authorization letter, plus:

A purchase and sale contract -- signed by you and the seller -- to buy the property for a specified price. The lender is not going to entertain tentative offers. You're not going to get the chance to ask the bank, "Would you

take X number of dollars?" In most cases this also means posting a sizable amount of money to demonstrate your desire and ability to go through with the transaction if it is accepted. If you can't make a sizable down payment, the lender has no reason to believe you can do any better than the last owner. It's also very important to the buyer that the contract be contingent upon all lenders approving the short sale in writing.

A hardship letter. It's important to remember that a lender will not even discuss a short sale until the homeowner has fallen behind on payments -- usually 90 days. The lender must be convinced taking a smaller loss now is better than a bigger loss later. To make that case, start with a letter written by the seller giving an overview of the seller's desperate situation. The lender must recognize the seller's inability to pay the loan -- immediately and in the foreseeable future -- and that the situation is irreversible. The seller should supply as much evidence and documentation as possible, such as divorce papers, evidence of job loss, delinquent accounts, utility shutoff notices, car repossession paperwork, the last two years' tax returns, recent pay stubs and recent bank statements. If the lender thinks the seller has money or assets stashed away, it will never go along with a short sale.

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A statement of the property's value. This can be an appraisal or a broker's price opinion. The lower the estimate of the property's current market value, the better it will be for you. You want to show the lender that the seller would not be able to get enough for the home via a normal sale to satisfy the loan. Compile a list of all the negatives and problems of the home that negatively affect the value and make it undesirable to the average buyer and tougher for the lender to resell. If the lender realizes the property will bring it nothing but headaches, it will be more likely to OK a short sale. MortgageReliefFormula.com's Geller, who has participated in hundreds of short sales, says this step is critical and advises taking it before the lender does a valuation. "There are ethical and legitimate ways to get a low valuation, and if you show this to the lender to start with, your offer won't look so low," he says. Geller adds the offer to the lender can be below the amount of valuation. "The offer can be 85% in areas that are slow but not terribly distressed and as low as 50% in really distressed areas."

[Continued: A detailed report](#)

A detailed report of the costs and liabilities. You want to show the lender it would be much better off letting you take the property off its hands. If you can convince the lender the home is a money pit, all the better. Take photos of any damage and get estimates of the repair costs. Note: This is also a good opportunity for you to take an honest look at the property and decide if you are willing and able to invest the time and money required to fix it up. Remember: A short sale is always an as-is sale. The lender is not going to pay for or otherwise be responsible for any repairs. But if the lender forecloses, there's a good chance it will be forced to make repairs just to get the house resold.

A settlement statement. This statement (which can be prepared by a closing agent or real-estate lawyer) outlines the purchase price, the closing costs and any other costs or fees involved in the transfer of the property. Often referred to as a net sheet, the information can be entered onto a HUD-1 Settlement Statement to show the final, negative result at closing.

9. Negotiate.

It's not uncommon for the lender to reject your offer or to come back with a counteroffer. As with any real-estate transaction, you should figure out beforehand what your absolute highest limit is and not be afraid to walk away if the lender won't meet your figure.

10. Seal the deal.

Once you've reached an agreement that all three parties (you, the seller and the lender) are OK with, get everything in writing and officially recorded. Make sure the seller understands all the terms of the deal. Next comes the closing, then the property is yours.

More important details

Title search: The entire process gets far more complicated and uncertain if there is more than one lender involved. Second or junior lenders often are the ones absorbing most of the loss. If there is a second mortgage or a home-equity line of credit, you'll need approval from all lenders involved. In addition, you may find your mortgage loan was sold to another entity in a process called securitization, and therefore you also need approval from that company.

Be sure to do a title search, and verify the lien position of the lender you plan to contact. Pursue short sales only with the primary lien holder. Making a deal with a junior lien holder is a waste of time, as you will still be on the hook to the primary lien holder for whatever is owed to it. **Tax break:** The Mortgage Forgiveness Debt Relief Act of 2007 gave short sellers a big tax break by changing the way the forgiven amount is viewed for tax purposes. Before passage of the act, that amount was considered as income for the seller and was subject to tax. However, the new law removed that tax liability.

Timing: While you negotiate with the lender, the clock keeps ticking. Do everything you can to get the lender to move quickly. Many short sales fall apart because the lender moves too slowly and fails to complete the deal before the property goes to auction.

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Credit: Some buyers have successfully negotiated with lenders to minimize damage to sellers' credit ratings. The lender has no obligation to agree to this, but if you can persuade it not to report the short sale as a black mark on the seller's record (and put this in writing as part of the deal), it will give the seller a big head start in rebuilding his or her financial life.

Typically, the loan will show up on a credit report as "paid," but it will carry a notation that says something like "settled for less than originally owed." That is more favorable than a foreclosure but still negative.

This story was reported and written by Bobbi Dempsey for Bankrate.com.

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