

Short Sale, Foreclosure, or Deed in Lieu: Which is Best for the Borrower?



If only the President's foreclosure-prevention plan worked as well as "cash for clunkers": But it hasn't. When the Administration announced the Making Homes Affordable plan in February of 2009, officials said they hoped it would help 4 million distressed homeowners to stay in their homes. As of this writing (8/2/09), the Administration has acknowledged that there are only 200,000 trial loan modifications under way.

Clearly, lenders have been reluctant to modify loans. (Moreover, there are good reasons for their reluctance according to a recent study by the Boston Federal Reserve.) Also, many borrowers have turned out to be ineligible for the programs or – because they are so far 'under water' – uninterested. Whatever the cause, the result is the same: a distressed borrower typically needs to choose between (1) a short sale (where the lender agrees to take less than the amount owed) in which, among other things, a commission (paid by the lender) is generated. (2) a foreclosure, or (3) a deed in lieu of foreclosure (where the borrower 'gives back' the property to the lender without a foreclosure proceeding). Which is better for the borrower?

Many real estate agents will say and advertise that a short sale is clearly preferable. In support of this view, two claims are usually asserted. (1) A short sale is less damaging to the borrower's credit than a foreclosure. (2) A short sale provides the borrower with a shorter 'waiting period' until the borrower will be able to purchase a home again.

It is important to note that these are two different claims. For example, in a period of time a borrower could become eligible for a purchase loan under Fannie Mae/Freddie Mac guidelines, but he or she might still not have sufficient credit or income to qualify for the loan.

While many say that a short sale is less damaging to one's credit than is a foreclosure, documenting that claim is another story. This writer has looked hard, but can't find any verification from Fair Issac (the developer of the FICO scoring system) or any of the major credit providers. That is probably no surprise, because their systems are proprietary. Nonetheless, one wonders what might be the source of the claim.

On the other hand, people who apparently should know deny that there is any difference. Greta Guest of the Free Press (Freep.com) quotes John Ulzheimer, president of consumer education for Atlanta-based Credit.com. Ulzheimer spent seven years at Fair Issac. "The credit bureau sees those all as equal," Ulzheimer said. "They are all essentially in the eyes of FICO a major delinquency." Elizabeth Razzi wrote in the Washington Post (July 20, 2008), "A foreclosure and short sale inflict equal damage to your FICO score, according to Fair Issac..." though she provides no specific citation.

Moving on from the credit score issue, there is the question of being again eligible to buy. More precisely, it is a question of when, in the future, the defaulting borrower could get a loan that would be purchased by Fannie Mae or Freddie

Mac. The issue is dealt with in Fannie Mae Announcement 08-16, released June 25, 2008.

When it comes to foreclosures and deeds in lieu of foreclosure, the policy distinguishes between events that were precipitated by extenuating circumstances (e.g. job loss, major illness) and those that were not (e.g. financial mismanagement). If you've had a foreclosure without extenuating circumstances, you can't purchase with a Fannie Mae – backed loan for five years. However, if there were extenuating circumstances, it drops to three years. Suppose you chose the deed in lieu of foreclosure option. If there were no extenuating circumstances, the period would be four years, but with such circumstances, it drops to two. Fannie Mae doesn't draw the distinction when it comes to short sales: the period is two years, the same as doing a deed in lieu with extenuating circumstances.

May 15, 2009, the Treasury Department issued an update to the Making Home Affordable plan. Among other things, it provides for financial incentives (e.g. a \$1,500 moving allowance) to distressed borrowers who meet the general eligibility requirements for a loan modification and who will engage in an approved short sale or who will give a deed in lieu of foreclosure.

Distressed and underwater borrowers face a minefield of options for resolving their problems. Not the least of their problems is the vast amount of misinformation floating around. They need to step very carefully.

