Ask John: What is a Short Sale and how will it Impact my Credit?

Hello John,

I am in the same boat as a bunch of other people. I live in a home that I can't sell because nobody will give me my asking price. If I go any lower on my price then I won't be able to get enough money to cover the loan amount. It's just a bad market. In 4 months my payment will adjust and I won't be able to afford it any longer. I have had some people offer me much less than what I think my home is worth. They keep telling me that I'll need to short sell. I keep hearing people talk about short sales. Can you explain what a short sale is and if it's a good idea for me?

Jim Prince,
Scottsdale Arizona

The Good News

Sure Jim, I'm happy to help and I commend you for making the effort to sell your home rather than just walking away from it. A short sale is essentially when your mortgage lender agrees to take less than the full principle loan amount and consider the loan paid in full. For example, if you owe $100,000 on your home loan and someone offers you $85,000 and your mortgage lender accepts the offer, they have allowed you to short sell the home. They have forgiven the difference of $15,000, which is called a deficiency balance. In the past, that $15,000 was taxable, but there is legislation in place now that excludes the deficiency balance on a short sale as taxable income.

Short sales are not new; however, they are much more common now because of our current mortgage environment. They offer hope to people who live in areas of the country where the value of real estate has declined sharply, like where you live. If your lender is willing to work with you, a short sale can help you get out from underneath a mortgage loan that just isn't appropriate for your situation any longer.

The Bad News

While a short sale is definitely a good move when you can't find someone to buy your home for the full loan amount, please don't think that you'll get off the hook without some problems. It is very likely that your credit scores will suffer, and could suffer greatly, because of the short sale. The reason that your scores will suffer is because of how your mortgage lender will report the loan to the credit reporting agencies.

We've discussed this before on AskJohn, but we need to bring it up again here. Remember: Credit scores are smart…but they are only as smart as the information on your credit reports. The ONLY way that credit scores know that you've disposed of your mortgage via a short sale is if your mortgage lender chooses to report that to the credit bureaus.

There are two ways that the loan can be reported. The first is "**Settlement accepted on this account.**" The second is "**Settled for less than the full loan amount**." The exact verbiage will vary by bureau but they all mean the same thing…that the loan has a $0 balance but was not paid in full according to the terms of the original loan agreement. Scoring models will consider this to be a serious negative item. In fact, and you're not going to like this, a **short sale is just as bad for your scores as a foreclosure.**

So if a short sale is just as bad as a foreclosure for my scores, then why bother?

There are two reasons why you should bother marketing your home for a short sale versus just walking away.

- *There's more to it than just the score* – Yes, your credit score is extremely important. We all know that. However, in the mortgage environment there is still a bit of latitude that your lender can use if he/she believes that you deserve a mortgage the next time you apply. In these cases, being able to show that you made the effort to satisfy some, if not the majority, of your previous mortgage can't hurt and may be the difference between getting an approval or a denial the next time you want to buy a home.
- *It's the right thing to do* – At the end of the day, we are all liable for our own debts since we're the ones who signed on the dotted line. And whether we're in a bad mortgage loan because of a rogue mortgage broker, or just because of plain old bad decision-making, we have to bear some, if not all, of the responsibility. If making good on the loan in full is impossible, making good on as much of it as possible is the next best and ethical action we can take.

We have to keep in mind that the money we borrowed isn't Monopoly money. It's money that came out of someone's pocket, albeit probably an investor. Put yourself in the investor's shoes for just a moment. Wouldn't you rather have $85,000 of your money back?

John

If you have a question, comment or story idea for John, he can be reached at AskJohn@credit.com.

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What's better for your scores, short selling or foreclosure?

October 16th, 2008

I started in the credit business in 1991 (Equifax) and up until early 2008 I had never been asked a single question about short selling a home. Since then I've been asked about short selling what seems like several hundred times. Let's address short selling; what is it, why would you do it, and how will it impact your credit reports and scores?

Short sale: A short sale is a deal cut with your current mortgage lender where they'll take less than the full loan amount to consider the mortgage satisfied and paid in full. For example, you owe $300,000 on a home and find a buyer will to give you $250,000. If the lender allows you to sell it for $50,000 less than you owe, it's been sold short.

Why short sell: Today when property values are going the wrong direction we find ourselves upside-down on the most expensive investment we'll ever make. We live with it (or at the very least have come to tolerate it) when we are upside-down on our car loans. But when we're throwing mortgage payments down the drain for the foreseeable future, some of us need to get out and get out now. Short selling offers hope for those in that situation.

What does a short sale look like on a credit report: There is no standard way to report a short sale. I've seen it reported as a "settlement" or "Account settled for less than full amount." Regardless, they both mean the same things to your FICO scores.

So what does it mean to my FICO scores? A short sale has the same damaging impact as a foreclosure. Let me repeat that because I know you just took a double take. When you short sell a home, it is reported as a settlement. And a settlement is just as damaging as a foreclosure to your scores. This means for the next seven years your scores are going to be lower because of the short sale. Of course this could easily be addressed by compelling lenders to NOT report short sales as foreclosures but simply show the loan paid in full.

We're here to help you in these tough times. As always, if you need to reach me you can do so at

John

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