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Short sales - There is a need to be informed - Part 2

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Part I of this two part series looked at the exploding market for short sale properties. Now, Part II will consider some of the problem areas associated with short sales.

A short sale is a sale of property when the sale price is lower than the amount owed on the existing mortgage(s). The number of homes that are considered "underwater" on the mortgage is estimated to be 24% of all homes with mortgages, or over 11 million homes nationwide. One way to avoid the foreclosure would be to sell the house and pay off the mortgage before the foreclosure happens. Lenders have become more willing to allow a short sale, even when they know there won't be enough money from the sale to pay the entire mortgage, because the loss may still be less than they face if they proceed with a foreclosure. And, the property owner gets the benefit of avoiding the black mark of foreclosure on their credit report.

Along with the many reasons why a short sale may be an advantage for all involved, there are also some disadvantages that all involved in a short sale need to be aware of. Some of these are inconveniences and increased transaction risks that result in delays, disappointments and obstacles. Other factors have to do with associated illegal activity and a growing level of fraudulent activity related to short sales.

The Downside: Delays, Disappointments and Obstacles

To be successful, an offer to purchase a short sale property must be approved not only by the property owner, but also by the lender/servicer. It has not been uncommon to take well over 6 months to get the approval. But anxious buyers often cannot wait that long, and may withdraw their offers before lender approval comes through. Many times the first offer is left with the lender to try to get through the process. If accomplished, that lender approval that may form the base for quicker approval of a new offer (if one is received).

When the property involved has both a first mortgage and a second mortgage or home equity line of credit, especially if the loans are from different lenders, the process becomes more complicated. If the short sale offer is for an amount that is less than the first mortgage, then that automatically means there is virtually no money available to lessen the loss on the second mortgage. Some lenders with a first mortgage will allow a few thousand dollars to go to the second mortgage in exchange for agreement to the deal. But many times that may not be enough to get second mortgage holder approval. If there is only one mortgage, but there is another lien of some sort (mechanics lien, tax lien, etc.) that second lien presents the same kind of challenges and may well mean that getting the short sale approved by the owner and the lender can still become either very complicated or even unachievable.

Another of the problems encountered has to do with the seller's finances. If, the borrower is unable to make the payments on the mortgage and on other obligations due to unemployment or other problems, the lender may be willing to consider the short sale. But, if the owner isn't in financial distress, the lender is likely to choose to hold the owner responsible for the mortgage as they signed it.

The Dark Side - Illegal and Fraudulent Activity

All of the parties to a short sale are thinking about valuation. Am I getting a fair price? Am I getting a discount from market value? Is the lender approving a sale price that minimizes their loss? With the huge volume involved, lenders often consider using alternative valuation products that are less expensive than a 'full appraisal'. Many times that valuation takes the form of a 'BPO' or Broker's Price Opinion that is performed by a real estate sales person. In fact, when the Treasury Department announced the new Home Affordable Foreclosure Alternatives (HAFA) program in April 2010, the program indicated that it will allow the use of BPOs to determine the value. That has raised concerns on several fronts.

First, there are 23 states including Connecticut where performing such a BPO as a valuation product for a fee (rather than as a service in the potential listing, sale or lease of property) is not allowed under state law. Real estate agents in Connecticut are in violation of state licensing law if they perform such a valuation.

Sometimes the illegal activity goes beyond just performing a banned service. With all the properties in distress, and all the billions of dollars involved, there are those who have found ways to tilt the system in their favor, fraudulently.

Neil Barofsky, special inspector general for the TARP program has been critical of the government's foreclosure prevention program. In his first quarter 2010 report to Congress, he said that to Treasury's credit, the changes made were an important step forward in addressing the flaws of HAMP. But he went on to say in the report that "No program of this type and scale can be considered well designed without robust protections of taxpayer funds against the predation of criminals".

One common short sale fraud scheme is called 'flopping'. It uses property values that are intentionally deflated in order to enable a decreased cost for the buyer in the short sale, often to a "straw buyer". The property is then quickly flipped, or "flopped", for the much higher actual market value producing a substantial profit for the crooks. The inspector general's report to Congress goes on to say that "Historically, these schemes often involve the participation of corrupt brokers and servicers. As constituted now, the program (HAFA) permits home valuation, a key vulnerability point for a flopping scheme, without a true appraisal, allowing estimates from brokers or other 'independent' providers at the discretion of the servicer...These less-than-robust valuation methods, along with the increased incentives through Government-funded payouts, leave the program vulnerable to fraud." The report then recommends that Treasury eliminate the valuation requirements that allow BPOs and substitute the FHA appraisal standard for all principal reduction and short sale programs.

For all who are attracted to the potential benefits that short sales bring to our distressed real estate markets, there also is a need to be informed, be aware of the pitfalls as well as the advantages, and to get good advice from qualified professionals before important financial decisions are made. The cost of that professional advice will look very cheap in comparison to the tens of thousands that might be lost without it.

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