

HELP FOR RESPONSIBLE HOMEOWNERS | MAY 2009

Stop “Short Sales” From Damaging Credit

By Anne Kim and Tess Stovall

With housing values continuing to slide, as many as one in five homeowners is “underwater”—owing more on the mortgage than the house is worth. For homeowners forced to sell under these circumstances, a so-called “short sale” can devastate someone’s credit rating—even for an otherwise responsible borrower. Homeowners who’ve done the right thing should be spared the double hit to both their home equity and their credit. Congress should temporarily bar credit rating agencies from downgrading the credit records of good borrowers in depressed neighborhoods who have had to short sell their homes.

THE PROBLEM

Short sales damage the credit of good borrowers

Almost every homeowner in America has suffered from the housing shock, and even long-time borrowers with solid credit and fixed-rate mortgages are increasingly finding themselves “underwater.” For those faced with the need to sell their homes—whether due to pursuit of a job in another state, a divorce or other change in life circumstances—a “short sale,” in which the sale price is less than the amount owed on the mortgage—may be the only responsible or realistic option.

But regardless of individual circumstances or motivations, the impact of a short sale on a borrower’s credit record is almost as negative as foreclosure.¹

A short sale can lower credit scores by as much as 200 to 300 points.²

A 200 to 300 point drop in credit scores can be devastating to a borrower. It can mean the difference between qualifying for lower-cost, prime interest rates or higher-cost, subprime loans. Since a short sale remains on a credit report for up to seven years,³ it has a lasting, punitive impact on homeowners whose

ability to obtain credit will be seriously impaired for the better part of a decade. In addition, borrowers who short sell their homes may have trouble obtaining another mortgage. Fannie Mae and Freddie Mac have recently announced policies requiring borrowers to wait at least two years before obtaining another mortgage following a short sale, regardless of their credit scores.⁴

Short sales are on the rise as more homeowners go underwater.

More than one-third of homes sold in 2008 were sold at a loss, and nearly 11% of those sold were short sales.⁵ These figures are likely to worsen. Already, between one in five and one in four homeowners is underwater,⁶ and another 2 million homeowners could be underwater if housing prices drop an additional 5%.⁷

Share of Homeowners Underwater Top 5 States (as of December 31, 2008)⁸

Nevada	55%
Michigan	40%
Arizona	32%
Florida	30%
California	30%

Short sale penalties are unfair to responsible borrowers.

Downgrading a borrower's credit record because of a short sale might have made sense when property values were on the rise and sellers conducting short sales were doing so because of circumstances within their control. But in today's economy, when homeowners are being broadly hit by declining housing prices, automatically penalizing short sales makes less sense. Moreover, it may incentivize some borrowers to simply walk away from their homes, which would have a worse impact on both the surrounding neighborhood and the overall housing market than a short sale would.

THE SOLUTION

A moratorium on penalties for short sales

To better protect responsible homeowners, Congress should temporarily bar credit reporting agencies from penalizing borrowers with otherwise solid credit records who report a short sale on their homes. It should also temporarily lift the waiting period (which can be as long as two to four years) for borrowers to obtain a new mortgage financed through Freddie Mac or Fannie Mae.

This would be temporary.

This moratorium on short sale penalties should only last until housing values begin to stabilize. This proposal is not intended to encourage a long-term intervention in how private credit rating agencies conduct their business.

Homeowners might choose the more responsible option of a short sale over a foreclosure.

For a lender and the surrounding neighborhood, a short sale can be far more desirable than foreclosure. Avoiding foreclosure can save a lender, on average, more than \$50,000 per foreclosed home,⁹ and short sales can take less time to complete.¹⁰ The lender can also avoid taking possession of a house, thereby avoiding the cost of maintenance and upkeep. And for the surrounding neighborhood, a short sale avoids the blight of a vacant house and could help stabilize home values. One foreclosure can hurt the values of 22 neighboring houses.¹¹

Only qualified short sellers would benefit.

This moratorium should only benefit homeowners who otherwise have good credit and are up to date on their mortgage payments.

■ CRITIQUES & RESPONSES***It rewards homeowners who made bad decisions.***

Quite the contrary. Rather, this proposal is primarily intended to help homeowners who must sell their house at a loss because of a major life change such as a job loss or a divorce. They should not be further punished for a widespread decline in housing values that is beyond their control. Moreover, by making both measures temporary, homeowners will not be encouraged to negotiate short sales with lenders once the economy and the housing market have recovered.

It would encourage more homeowners to short sell their homes.

For many, a short sale is the best possible option in a tough situation. Most homeowners would not be quick to choose a short sale, but when faced with the need to move out of a home, the decision to negotiate a short sale over simply walking away from the home is the best decision for the homeowner, the lender and the neighborhood.

This interferes too much with the business of private credit reporting agencies.

This is a temporary and necessary intervention to end a practice that is currently doing more harm than good to homeowners in the current economy. Downgrading good borrowers for short sales could ultimately further damage the economy by making it unnecessarily difficult for responsible borrowers to obtain credit.

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■ ENDNOTES

- 1 MyFICO.com, Credit Education Center, <http://www.myfico.com/CreditEducation/questions/foreclosure-alternatives-fico-score.aspx>
- 2 Judi Hasson, "Homeowners Who Just Walk Away," MSN Money, April 9, 2008, available at <http://articles.moneycentral.msn.com/Banking/HomeFinancing/HomeownersWhoJustWalkAway.aspx?page=1>.
- 3 Christopher Palmeri, "Is a Short Sale Right for You?" Business Week, October 16, 2008, available at http://www.businessweek.com/bwdaily/dnflash/content/oct2008/db20081015_578346.htm?chan=investing_investing+index+page_real+estate.
- 4 In July 2008, Fannie Mae announced a two-year waiting period after a short sale before a person will be able to get another mortgage financed through Fannie Mae. (Fannie Mae, Announcement 08-16, June 25, 2008, available at <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2008/0816.pdf>.) For Freddie Mac, a borrower has to wait two years if a short sale is due to circumstances beyond their control and four years if it was due to the borrower's financial mismanagement. (June Fletcher, "Short Sale Vs. Foreclosure," Wall Street Journal, November 22, 2008).
- 5 Stan Humphries, "Americans Lose \$1.4 Trillion in Home Values in Q4," Zillow.com, February 2, 2009, available at <http://www.zillowblog.com/americans-lose-14-trillion-in-home-values-in-q4/2009/02/>.
- 6 First American CoreLogic estimated that one in five homeowners with mortgages were underwater as of December 2008. (Jonathan Stempel, "One in five U.S. mortgage borrowers are underwater," Reuters, March 4, 2009). Moody's Economy.com estimated that 27% of homeowners with mortgages were underwater. (Associated Press, "Obama unveils \$75B mortgage relief plan," February 18, 2009, available at <http://www.msnbc.msn.com/id/29256639/>.)
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- 8 Barbara Kiviat, "Nearly 1 in 5 Owe More Than Homes Are Worth," Time, March 4, 2009, available at <http://www.time.com/time/business/article/0,8599,1882975,00.html>.
- 9 Desire Hatcher, "Foreclosure Alternatives: A Case for Preserving Homeownership," Chicago Federal Reserve, February 2006, available at http://www.chicagofed.org/community_development/files/02_2006_foreclosure_alt.pdf.
- 10 A short sale can take between two to six months to complete. Joe Light, "Snag a great deal on a short sale," CNNMoney.com, January 28, 2009, available at http://money.cnn.com/2009/01/27/real_estate/short_sale.moneymag/index.htm?postversion=2009012806.
- 11 Broderick Perkins, "Foreclosure Fallout Landing On Neighboring Homes," Realty Times, February 13, 2008, available at http://realtytimes.com/rtpages/20071115_foreclosurefall.htm.