

## What is a Short Sale?

A short sale is the sale of a property for less than what is owed on it. The lenders voluntarily accept less than full payment and forgive the unpaid balance. This happens when a property is worth less than what is owed, the owner is insolvent, and can't make up the difference. In the *sale* of the property, a lender is paid off with a dollar value *short* of what it is owed, thus the term *short sale*. This article briefly explains why this happens and why they are so common.

The root of this issue is in collateralization. The vast majority of properties are purchased with the aid of financing. In order to pay for a property, a homeowner places a small down payment. Since the down payment is not sufficient to purchase the property, a loan is used to pay the remainder of the acquisition value. In other words, the homeowner finances part of the purchase value of the property with a loan from a lender. To guarantee payment, the homeowner pledges the property as collateral. This is called collateralization. This is an agreement between the owner and the lender, such that in case of default, the lender has the right to dispose of the property in order to get paid. In the U.S., properties are collateralized by trust deed, mortgage, and security deed. The term "mortgage" is generic.

Complete and timely payments incrementally reduce the loan payoff value. That is called amortization. The longer payments are made, the more amortized the loan becomes. A fully amortized loan is a loan with zero balance and paid off. On the other hand, because of interest, missed payments increase the loan payoff. That is called accrual.

At sale, unless the loan is fully amortized, the homeowner needs to payoff the remaining debt balance. If the property sale value is high enough, the proceeds of the sale will be sufficient to pay off the loan and for the homeowner to earn a profit or break even. If not, there will be a shortfall. To make up for this shortfall, either the homeowner will have to make up for the amount needed to pay off the loan, or the creditor will have to take less than the amount owed.

A property worth less than what is owed is "over-mortgaged". The main reasons properties become over-mortgaged include the owner paying too much, refinancing for too much, market decline, damage, deferred maintenance, negative neighborhood changes and disasters.

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9220 SW Barbur Blvd  
Suite 119; Box 159  
Portland, OR 97219

Often, owners of over-mortgaged properties needing to sell are unable to make up for the loan payment shortfall. It gets worse if they are insolvent. Usually, seeing only losses, they sooner or later get discouraged and become uncommitted to the property. This leads to default. Once this happens, it gets worse. The loan starts to accrue. Unpaid property taxes, utilities, and other costs also accumulate. In addition, usually maintenance is deferred. The property may even be abandoned. This results in further loss of value.

Once the property enters into this cycle, it becomes the lender's problem. The longer it passes, the worse it gets. Urgently, the lender needs to recover as much of the debt as possible. Lenders in this situation have only two alternatives. One of them is to foreclose. The other is to allow the homeowner to sell the property for less than what is owed. This is a short sale. Either way, the creditor will take a loss.

Unless the property value is high enough, a lender that decides to foreclose only stands to lose. Only cash-in-hand investors looking for great deals buy at foreclosure sales. If the property is not sold at a significant enough discount, the creditor will have to keep the property. If this happens, the creditor will be liable for maintaining the property, insuring it, paying taxes, and many other costs. Not only that, to sell it, the lender will have to pay commissions!

Foreclosures are costly, lengthy and hostile transactions. Even in an appreciating market, every day the property is worth less. Once in foreclosure, the property enters a legal limbo full of risks for the lender. Hopefully, the homeowner stays until shortly before the foreclosure, does not damage the property and leaves amiably. However, there is a high chance that the homeowner will abandon the property. Vandalism often follows. If neither happens, it is because the homeowner wants to stay longer. These homeowners usually file for bankruptcy. The result is a longer foreclosure and further loss to the lender.

Shortsales are lower cost, shorter and more amiable transactions. They are a much less risky alternative to foreclosure because most of the above mentioned problems are avoided. The insolvent homeowner sells the property for less than what is owed. The lender gets paid off sooner and forgives any debt shortfall. That is a short sale. That is why they happen and why they are so common.

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