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Two Alternatives to Foreclosure

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By EMILY GREEN

The housing legislation that is close to becoming law may help as many as 500,000 cash-strapped homeowners avoid foreclosure, by assisting them in refinancing into more-affordable government-backed mortgages.

**Counseling Resources for
Struggling Homeowners**

Neighborhood Assistance Corp. of America
naca.com
1-888-302-6222

ACORN
acorn.org
1-866-672-2676

Homeownership Preservation Foundation
995hope.org
1-888-995-4673

HomeFree-USA
homefreeusa.org
1-866-696-2329

But since many struggling borrowers may not qualify, people facing foreclosure should also familiarize themselves with two other options: "short sales" and "deed in lieu of foreclosure" transactions.

Neither option will keep you from losing your house or avoid severe damage to your credit score. Still, they may be less painful in some ways than foreclosure, the legal process in which the bank repossesses a homeowner's property because of failure to meet the terms of the mortgage.

In a short sale, the borrower sells the house at a fair market value that is less than the amount owed on the mortgage, and the lender usually agrees to forgive the remainder of the debt.

In the other option, the borrower hands over the property to the lender with the lender's consent "in lieu of" waiting for foreclosure. The obligation falls on the lender to sell the house; as in a short sale, the lender typically agrees to forgive the amount by which the mortgage balance exceeds the house's current value.

Put Debt Behind You

A key advantage of both strategies is that most individuals walk away from their house freed of their mortgage debt, a psychological and legal relief, says Vicki Vidal, an associate vice president at the Mortgage Bankers Association.

In contrast, in foreclosure proceedings, lenders can theoretically pursue the differential owed to them, depending on state law. The great majority of lenders don't pursue this debt, but it has occurred, particularly in cases where the borrower vandalized the property upon departure.

A second benefit of short sales and deeds in lieu of foreclosure is that borrowers will generally face a shorter waiting period before they can obtain another mortgage.

Many lenders primarily make loans that they can sell to big mortgage players Fannie Mae and Freddie Mac. Starting Aug. 1, Fannie Mae generally will not buy loans made to borrowers involved in a short sale in the past two years. That's shorter than the four-year wait time if you have a deed in lieu of foreclosure on your record, and the five-year wait time if you have a foreclosure on record. (The current wait time is four years for a foreclosure or a deed in lieu of foreclosure; there is no existing policy for borrowers with a short sale.)

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Housing Lenders Feel Heat

Freddie Mac generally won't guarantee loans made to borrowers who have had a foreclosure in the past four years, says Freddie Mac spokesman Brad German. (If the foreclosure was due to circumstances beyond the borrower's control, such as a medical emergency, then Freddie Mac will guarantee the loan in two years' time). The company considers short sales and deeds in lieu of foreclosure a significant negative but not an "automatic no," says Mr. German.

A Blow to Credit Scores

What short sales and deeds in lieu of foreclosure don't do is minimize the impact on a borrower's credit score. All three proceedings have roughly the same negative impact on an individual's credit score, says Craig Watts, spokesman for Fair Isaac Corp., which created the widely used FICO score.

Mr. Watts says that to date little analysis has been done distinguishing, for instance, the credit risk of individuals who completed a short sale versus those involved in a foreclosure. For that reason, "the model ends up treating them [a short sale, a deed in lieu of foreclosure, and a foreclosure] all the same."

If homeowners are interested in pursuing a short sale, they should open discussions with their lender or loan servicer before attempting to sell their house.

For both short sales and deeds in lieu of foreclosure, borrowers will have to present a "hardship letter" to the lender or servicer detailing why they are unable to make their mortgage payments.

Lenders have shown increasing willingness to negotiate short sales and deeds in lieu of foreclosure because of the losses they frequently incur in foreclosures.

Short sales are considered preferable because they save lenders the hassle of selling the house. But a deed in lieu of foreclosure also has its advantages to lenders versus foreclosure: "The earlier they get the home, the better the condition the property is in," says Ms. Vidal of the Mortgage Bankers Association.

Still, for both short sales and deeds in lieu of foreclosure, the process of negotiating with lenders can quickly become complicated. If a borrower took out second and third mortgages, he or she may need to negotiate with multiple firms.

Whether attempting a short sale or a deed in lieu of foreclosure, borrowers should take a "proactive approach," says John Snyder, homeowner specialist with the nonprofit NeighborWorks America.

He recommends that borrowers who foresee problems making their mortgage payments contact a nonprofit organization to help them negotiate with their lending institution.

Write to Emily Green at emily.green@wsj.com

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