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The Pain of Selling a Home for Less Than the Loan

By DAVID STREITFELD

Many Americans are discovering an unfortunate twist to the housing crisis: even after selling a home and moving away, they might have to keep paying on it for years, even decades.

With home prices tumbling, millions of people owe more on their mortgages than the houses are worth. If a new job or other life change compels them to sell, their choices include bringing a pile of cash to the closing to make the bank whole, going into foreclosure or cutting a deal with the lender to pay off the balance of the loan over time.

How sellers will react when confronted with these unappealing options is one of the biggest questions hanging over Wall Street as it tries to move beyond the carnage overwhelming such venerable firms as Lehman Brothers, American International Group and Merrill Lynch.

A sale for less than the value of the mortgage on a property is known as a “short sale,” because the transaction leaves a homeowner short of the funds needed to settle the debt. Agents and lenders say the number of short sales is rising markedly.

Reluctantly, banks are agreeing to let some short sales go through. But instead of writing off the unpaid portion of the debt, they want homeowners to sign a note promising to pay some or all of the balance due.

This was the situation confronting Mike and Linda Kelly, who needed to sell their house in the foreclosure-plagued Central Valley of California when Mr. Kelly got a new job 75 miles away.

The Kellys owe $300,000 on their house, which has a pool in the back, crepe myrtle bushes in front and, because Mr. Kelly is a ham radio buff, a 40-foot antenna above it. But the best offer they could get gave the bank $220,000.

CitiMortgage said it would approve a sale at that price, but at the last minute told the Kellys they needed to pay $166 a month for the next 20 years, a total of $40,000.

“When you are ready to participate in the loss, feel free to call me,” a Citi loss mitigation specialist, April Easter, wrote to them in an e-mail message.

Moody’s Economy.com estimates that about 10 million homeowners have negative equity, a condition known colloquially as being upside down or underwater. By next June, the forecasting company expects the total to rise to 12.7 million — a quarter of all homeowners who have mortgages.

Owners in this predicament who must sell, like the Kellys, have few alternatives if they are not flush.

“The first wave of foreclosures involved a lot of investors who just disappeared,” said Lance Churchill of

Frontline Seminars, which teaches real estate agents how to negotiate with lenders on short sales. “Now, homeowners with jobs and assets are underwater and want to sell. The banks want as much as they can get, today or in the future, and the owners want to get away clean.”

This clash is a central aspect of the financial crisis engulfing Wall Street. During the boom, millions of mortgages were bundled into bonds that were sold to investors and banking houses. But with real estate prices falling and mortgage defaults rising, it has become nearly impossible to calculate the worth of those bonds, and investors are fleeing them.

Lenders like Citi — which has already lost more than $50 billion in ill-advised real estate-related ventures — are walking a tightrope.

If they do short sales without trying to extract anything from the sellers, everyone in the country who is upside down could try to wriggle out. The banks and bondholders will take a fresh wave of hits; some might not survive. But if a lender drives too hard a bargain, the owner can default, leaving the bank worse off than if it had taken the short sale.

“It’s a game of chicken, with huge consequences for the banks, the borrowers and the economy,” Mr. Churchill said.

Lenders’ demands take many forms. Mary Gonzalez, an agent in San Jose, had to stave off a request from a mortgage company that her client take cash advances on her credit cards to settle a mortgage debt. That lender eventually agreed to settle for a few thousand dollars.

At the other extreme, JPMorgan Chase says it wants short sellers to sign a note for the full balance due, with interest, over 30 years if necessary.

While there are no authoritative national numbers on short sales, a related statistic — the number of people selling their homes for less than they paid — is rising rapidly, at least in California.

In August, 54.2 percent of Californians who sold their homes suffered a loss, a sharp rise from 16.8 percent in August 2007. Today’s number exceeds the peak of 53.2 percent reached at the end of the last downturn in January 1996, according to the research firm DataQuick. (In some of those cases, the sellers may have lost their down payment without necessarily incurring a cash shortfall at closing.)

The foreclosure option is, in theory, bad for everyone. Short sales offer all parties the ability to cut their losses earlier. But they also bring homeowner and lender into direct conflict on the contentious issue of who was responsible for those losses in the first place.

Many borrowers went wild during the boom, buying multiple properties at high prices, signing outlandish loans, taking out large sums to live in high style. But none of that would have been possible, of course, if banks chasing quick profits had not abandoned their lending standards.

The Kellys, both 64, did not join the free-for-all. He works in financial services; she is a doting grandmother and a volunteer at the local blood bank. “We’re not loaded,” Mrs. Kelly said.

They bought their home in December 2001 for $225,000. They refinanced once, four years later, taking out

$75,000 to do improvements. At the time, the house was appraised at $450,000, seeming to offer a sufficient cushion.

But then the market tanked. Last winter, when the Kellys first began looking into selling, they knew any offer would be far below what they owed, and they could not afford to make up the deficit. So they began talking to Citi about their options. They did not want to surrender the house to foreclosure, ruining their credit, hurting their neighbors and betraying their image of themselves.

“We’ve never defaulted on any obligation through our whole lives,” said Mr. Kelly, a former marine who had served in Vietnam.

Citi sent the Kellys a letter saying, “We look at mortgages as partnerships.” The lender said it would be willing to let the home be sold for its fair market value, “even if the proceeds are less than the total amount owed.” Additional payments over the decades were not mentioned.

The Kellys had to jump through many hoops, surrendering their financial documents and explaining why they merited approval for a short sale. Only when a buyer was in hand and a price had been negotiated did Citi demand the $40,000 promissory note from the Kellys.

A spokesman for Citi, while declining to comment specifically on the Kelly case, said the amount each seller is asked to provide is determined by “affordability criteria,” and the sum is negotiable. But the e-mail exchanged between the Kellys and their Citi case worker do not show much evidence of negotiation.

“Lenders always say, ‘Don’t stick your head in the sand, come work with us,’ ” Mr. Kelly said. “I have found the truth to be absolutely the opposite. They have fought us every step of the way.”

Mr. Kelly did not want to pay the $40,000, but Mrs. Kelly had qualms about the couple’s thumbing their noses at the bank. “I wonder about suddenly someone knocking at the door with some awful bill to be paid,” she said.

Foreclosure laws vary among states but in some circumstances, a bank can go after borrowers for the balance due on a mortgage even after it has taken possession of the house. That has not begun to happen in large numbers, but many people believe it will.

“If you have substantial losses from borrowers with a substantial ability to pay, it makes sense to take them to court,” said William Markham, a foreclosure expert at the law firm Maldonado & Markham in San Diego. He thinks the threshold for suits is a six-figure loss on the house and a borrower with a six-figure income.

People in the industry say banks sometimes tell borrowers that their credit will take less of a hit if they agree to sign a promissory note than if they default. It is not true. In both cases, credit agencies consider the homeowner to have failed to live up to a solemn obligation.

“Your credit report is going to be equally bad with a short sale as a foreclosure,” said Maxine Sweet, a vice president of the credit bureau Experian.

It is true, however, that people who sign a promissory note may have an easier time buying a new house than people who have gone into foreclosure; guidelines imposed by Fannie Mae, the mortgage giant, treat

foreclosure as a particular black mark in getting a fresh mortgage.

As the summer began, Mr. Kelly was getting tired of commuting for several hours every day to his new job. He asked Citi if it would accept half of what it was demanding, or $20,000. Before the lender could answer, their buyer backed out.

Feeling trapped, the Kellys are increasingly angry at Citi and other financial firms. “They damaged our economy and don’t take any of the responsibility, not really,” Mrs. Kelly said. Nevertheless, on Aug. 26, she mailed in the September mortgage payment.

A few days later, Mr. Kelly was abruptly laid off, along with 20 of his colleagues. He landed a new job on Monday but the offer was withdrawn on Wednesday. Too much economic turmoil for us to be adding staff, the company said.

Only one thing gives Mrs. Kelly any satisfaction. “Citi should have taken care of this when they could have,” she said. “Now there’s going to be nothing for them to get.”

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