From the Author of the Best-Selling Book, *Flipping Properties*

FINANCING SECRETS OF A MILLIONAIRE REAL ESTATE INVESTOR

WILLIAM BRONCHICK

FINANCING SECRETS of a MILLIONAIRE REAL ESTATE INVESTOR

FINANCING SECRETS of a MILLIONAIRE REAL ESTATE INVESTOR

WILLIAM BRONCHICK

Dearborn™
Trade Publishing
A Kaplan Professional Company

Vice President and Publisher: Cynthia A. Zigmund
Editorial Director: Donald J. Hull
Senior Managing Editor: Jack Kiburz
Interior Design: Lucy Jenkins
Cover Design: Design Alliance, Inc.
Typesetting: Elizabeth Pitts

Published by Dearborn Trade Publishing
A Kaplan Professional Company

Printed in the United States of America

03 04 05 06 07 10 9 8 7 6 5 4 3 2 1

Library of Congress Cataloging-in-Publication Data

Bronchick, William.
Financing secrets of a millionaire real estate investor / William Bronchick.
p. cm.
Includes index.
ISBN 0-7931-6820-1 (7.25 × 9 pbk.)
1. Mortgage loans—United States. 2. Secondary mortgage market—United States. 3. Real property—United States—Finance. 4. Real estate investment—United States—Finance. I. Title.
HG2040.5.U5B767 2003
332.7′22—dc21

2003000057

CONTENTS

1. Introduction to Real Estate Financing 1

- Understanding the Time Value of Money 2
- The Concept of Leverage 2
- Owning Property "Free and Clear" 5
- How Financing Affects the Real Estate Market 6
- How Financing Affects Particular Transactions 7
- How Real Estate Investors Use Financing 8
- When Is Cash Better Than Financing? 9
- What to Expect from This Book 10
- Key Points 10

2. A Legal Primer on Real Estate Loans 11

- What Is a Mortgage? 11
  - Promissory Note in Detail 12
  - The Mortgage in Detail 14
  - The Deed of Trust 15
- The Public Recording System 15
- Priority of Liens 16
- What Is Foreclosure? 17
  - Judicial Foreclosure 17
  - Nonjudicial Foreclosure 18
  - Strict Foreclosure 19
- Key Points 19

3. Understanding the Mortgage Loan Market 21

- Institutional Lenders 21
- Primary versus Secondary Mortgage Markets 22
- Mortgage Bankers versus Mortgage Brokers 23
- Conventional versus Nonconventional Loans 25
  - Conforming Loans 25
  - Nonconforming Loans 28

Government Loan Programs 28
Federal Housing Administration Loans 29
The Department of Veterans Affairs 30
State and Local Loan Programs 31
Commercial Lenders 31
Key Points 32

4. Working with Lenders 33
Interest Rate 33
Loan Amortization 34
15-Year Amortization versus 30-Year Amortization 36
Balloon Mortgage 37
Reverse Amortization 38
Property Taxes and Insurance Escrows 38
Loan Costs 39
Origination Fee 39
Discount Points 39
Yield Spread Premiums: The Little Secret Your Lender Doesn't Want You to Know 39
Loan Junk Fees 40
"Standard" Loan Costs 41
Risk 44
Nothing Down 45
Loan Types 46
Choosing a Lender 48
Length of Time in Business 49
Company Size 50
Experience in Investment Properties 50
How to Present the Deal to a Lender 51
Your Credit Score 52
Your Provable Income 56
The Property 56
Loan-to-Value 58
The Down Payment 59
Income Potential and Resale Value of the Property 60
Financing Junker Properties 60
Refinancing—Worth It? 61
Filling Out a Loan Application 61
Key Points 62

5. Creative Financing through Institutional Lenders 63

Double Closing—Short-Term Financing without Cash 63
- Seasoning of Title 65

The Middleman Technique 67
- Case Study #1: Tag Team Investing 69
- Case Study #2: Tag Team Investing 70

Using Two Mortgages 71

No Documentation and Nonincome Verification Loans 72
- Develop a Loan Package 75

Subordination and Substitution of Collateral 76
- Case Study: Subordination and Substitution 77

Using Additional Collateral 79
- Blanket Mortgage 79
- Using Bonds as Additional Collateral 80

Key Points 82

6. Hard Money and Private Money 83

Emergency Money 83

Where to Find Hard-Money Lenders 84

Borrowing from Friends and Relatives 85

Using Lines of Credit 86

Credit Cards 86

Key Points 87

7. Partnerships and Equity Sharing 89

Basic Equity-Sharing Arrangement 90
- Scenario #1: Buyer with Credit and No Cash 90
- Scenario #2: Buyer with Cash and No Credit 91
- Your Credit Is Worth More Than Cash 91
- Tax Code Compliance 92
- Pitfalls 93
- Alternatives to Equity Sharing 93

Joint Ventures 94
- Using Joint Venture Partnerships for Financing 94
- Legal Issues 95

Alternative Arrangement for Partnership 95
- Case Study: Shared Equity Mortgage with Seller 96

When Does a Partnership Not Make Sense? 97

Key Points 98

8. The Lease Option 99

Financing Alternative 100
Lease—The Right to Possession 100
Sublease 100
Assignment 100
More on Options, the "Right" to Buy 101
An Option Can Be Sold or Exercised 102
Alternative to Selling Your Option 102
The Lease Option 103
The Lease Purchase 103
Lease Option of Your Personal Residence 104
The Sandwich Lease Option 106
Cash Flow 107
Equity Buildup 107
Straight Option without the Lease 108
Case Study: Sandwich Lease Option 109
Sale-Leaseback 110
Case Study: Sale-Leaseback 111
Key Points 112

9. Owner Financing 113

Advantages of Owner Financing 115
Easy Qualification 115
Cheaper Costs 116
Faster Closing 116
Less Risk 116
Future Discounting 117
Assuming the Existing Loan 117
Assumable Mortgages 117
Assumable with Qualification 118
Buying Subject to the Existing Loan 118
Risk versus Reward 119
Convincing the Seller 120
A Workaround for Down-Payment Requirements 121
Installment Land Contract 122
Benefits of the Land Contract 124
Problems with the Land Contract 125
Using a Purcahse Money Note 125
Variation: Create Two Notes, Sell One 126
Another Variation: Sell the Income Stream 126

Wraparound Financing 127
The Basics of Wraparound Financing 127
Wraparound versus Second Mortgage 130
Mirror Wraparound 132
Wraparound Mortgage versus Land Contract 133
Key Points 133

10. Epilogue 135

Appendix A Interest Payments Chart 139
Appendix B State-by-State Foreclosure Guide 141
Appendix C Sample Forms 143
Uniform Residential Loan Application [FNMA Form 1003] 144
Good Faith Estimate of Settlement Costs 148
Settlement Statement [HUD-1] 149
Note [Promissory—FNMA] 151
California Deed of Trust (Short Form) 153
Mortgage [Florida—FNMA] 155
Option to Purchase Real Estate [Buyer-Slanted] 171
Wrap Around Mortgage [or Deed of Trust] Rider 173
Installment Land Contract 174
Subordination Agreement 176
Glossary 179
Resources 187
Suggested Reading 187
Suggested Web Sites 188
Real Estate Financing Discussion Forums 188
Index 189

CHAPTER 1

Introduction to Real Estate Financing

Knowledge is power.

—Francis Bacon

In 1991, I made my first attempt at financing an investment property through creative means. With a lot of guts and a little knowledge, I made an offer that was accepted by the seller. I tendered $1,000 as earnest money on the sales contract, then proceeded to try to make the deal work. I failed, lost my $1,000, but I learned an important lesson—a little knowledge can be dangerous. I decided then to become a master at real estate finance.

Financing has traditionally been, and will always be, an integral part of the purchase and sale of real estate. Few people have the funds to purchase properties for all cash, and those that do rarely sink all of their money in one place. Even institutional and corporate buyers of real estate use borrowed money to buy real estate.

This book explains how to utilize real estate financing in the most effective and profitable way possible. Mostly, this book focuses on acquisition techniques for investors, but these techniques are also applicable to potential homeowners.

Understanding the Time Value of Money

In order to understand real estate financing, it is important that you understand the time value of money. Because of inflation, a dollar today is generally worth less in the future. Thus, while real estate values may increase, an all-cash purchase may not be economically feasible, because the investor's cash may be utilized in more effective ways.

The cost of borrowing money is expressed in interest payments, usually a percent of the loan amount. Interest payments can be calculated in a variety of ways, the most common of which is simple interest. Simple interest is calculated by multiplying the loan amount by the interest rate, then dividing it up into period (12 months, 15 years, etc).

☛ **Example:** A $100,000 loan at 12% simple interest is $12,000 per year, or $1,000 per month. To calculate monthly simple-interest payments, take the loan amount (principal), multiply it by the interest rate, and then divide by 12. In this example, $100,000 × .12 = $12,000 per year ÷ 12 = $1,000 per month.

Mortgage loans are generally not paid in simple interest but rather by amortization schedules (discussed in Chapter 4), calculated by amortization tables (see Appendix A). *Amortization,* derived from the Latin word "amorta" (death), is to pay down or "kill" a debt. Amortized payments remain the same throughout the life of the loan but are broken down into interest and principal. The payments made near the beginning of the loan are mostly interest, while the payments near the end are mostly principal. Lenders increase their return and reduce their risk by having most of the profit (interest) built into the front of the loan.

The Concept of Leverage

Leverage is the process of using borrowed money to make a return on an investment. Let's say you bought a house using all of your cash for $100,000. If the property were to increase in value 10 percent

The Federal Reserve and Interest Rates

The Federal Reserve (the Fed) is an independent entity created by an Act of Congress in 1913 to serve as the central bank of the United States. There are 12 regional banks that make up the Federal Reserve System. While the regional banks are corporations whose stock is owned by member banks, the shareholders have no influence over the Federal Reserve banks' policies.

Among other things, the function of the Fed is to try to regulate inflation and credit conditions in the U.S. economy. The Federal Reserve banks also supervise and regulate depository institutions.

So how does the Fed's policy affect interest rates on loans? To put it simply, by manipulating "supply and demand." The Fed changes the money supply by increasing or decreasing reserves in the banking system through the buying and selling of securities. The changes in the money supply, in turn, affect interest rates: the lower the supply of money, the higher the interest rate that is charged for loans between banks. The more it costs a bank to borrow money, the more they charge in interest to consumers to borrow that money. The preceding is a simplified explanation, because there are other factors in the world economy that affect interest rates and money supply. And, of course, there are also widely varying opinions by economists as to what factors drive the economy and interest rates.

over 12 months, it would now be worth $110,000. Your return on investment would be 10 percent annually (of course, you would actually net less because you would incur costs in selling the property).

Equity = Property value – Mortgage debt

If you purchased a property using $10,000 of your own cash and $90,000 in borrowed money, a 10 percent increase in value would still result in $10,000 of increased equity, but your return on cash is 100 percent ($10,000 investment yielding $20,000 in equity). Of course, the borrowed money isn't free; you would have to incur loan costs and interest payments in borrowing money. However, by renting the property in the meantime, you would offset the interest expense of the loan.

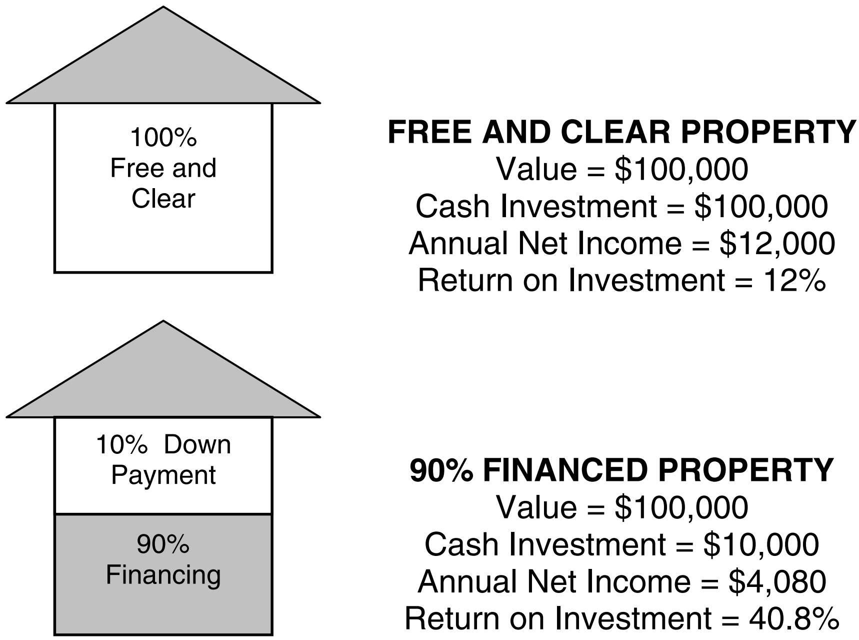
Calculating Return on Investment

Annual return on investment (ROI) is the interest rate you yield on your cash investment. It is calculated by taking the annual cash flow or equity increase and dividing it by the amount of cash invested.

Let's also look at the income versus expense ratios. If you purchased a property all cash for $100,000 and collected $1,000 per month in rent, your annual cash-on-cash return is 12 percent (simply divide the annual income, $12,000, by the amount of cash invested, $100,000).

If you borrowed $90,000 and the payments on the loan were $660 per month, your annual net income is $4,080 ($12,000 – [$660 × 12]), but your annual cash-on-cash return is about 40 percent (annual cash of $4,080 divided by $10,000 invested).

FIGURE 1.1 Owning Free and Clear versus Mortgaging



So, if you purchased ten properties with 10 percent down and 90 percent financing, you could increase your overall profit by more than threefold. Of course, you would also increase your risk, which will be discussed in more detail in Chapter 4.

Owning Property "Free and Clear"

For some investors, the goal is to own properties "free and clear," that is, with no mortgage debt. While this is a worthy goal, it does not necessarily make financial sense. See Figure 1.1.

☛ **Example:** Consider a $100,000 property that brings in $10,000 per year in net income (*net* means gross rents collected, less expenses, such as property taxes, maintenance, utilities, and hazard insurance). The $100,000 in equity thus yields a 10 percent annual return on investment ($10,000, the annual net cash flow, divided by $100,000, the equity investment).

If the property were financed for 80 percent of its value ($80,000) at 7.5 percent interest, the monthly payment would be approximately $560 per month, or $6,720 per year. Net rent of $10,000 per year minus $6,720 in debt payments equals $3,280 per year in net cash flow. Divide the $3,280 in annual cash flow by the $20,000 in equity and you have a 16.4 percent return on investment. Furthermore, with $80,000 more cash, you could buy four more properties. As you can see, financing, even when you don't necessarily "need" to do so, can be more profitable than investing all of your cash in one property.

How Financing Affects the Real Estate Market

Because financing plays a large part in real estate sales, it also affects values; the higher the interest rate, the larger your monthly payment. Conversely, the lower the interest rate, the lower the monthly payment. Thus, the lower the interest rate, the larger the mortgage loan you can afford to pay. Consequently, the larger the mortgage you can afford, the more the seller can ask for in the sales prices.

Also, people with less cash are usually more concerned with their payment than the total amount of the purchase price or loan amount. On the other hand, people with all cash are more concerned with price. Because most buyers borrow most of the purchase price, the prices of houses are affected by financing. Thus, when interest rates are low, housing prices tend to increase, because people can afford a higher monthly payment. Conversely, when interest rates are higher, people cannot afford as much a payment, generally driving real estate prices down.

Since the mid-1990s, the prices of real estate have dramatically increased in most parts of the country. The American economy has grown, the job growth during this period has been good, but most important, interest rates have been low.

How Financing Affects Particular Transactions

When valuing residential properties, real estate appraisers generally follow a series of standards set forth by professional associations (the most well-known is the Appraisal Institute). Sales of comparable properties are the general benchmark for value. Appraisers look not just at housing sale prices of comparable houses, but also at the financing associated with the sales of these houses. If the house was owner-financed (discussed in Chapter 9), the interest rate is generally higher than conventional rates and/or the price is inflated. The price is generally inflated because the seller's credit qualifications are looser than that of a bank, which means the buyer will not generally complain about the price.

Take a Cue from Other Industries

The explosion of the electronics market, the automobile market, and other large-ticket purchase markets is directly affected by financing. Just thumb through the Sunday newspapers and you will see headlines such as "no money down" or "no payments for one year." These retailers have learned that financing moves a product because it makes it easier for people to justify the purchase. Likewise, the price of a house may be stretched a bit more when it translates to just a few dollars more per month in mortgage payments.

Appraisals on income properties are done in a variety of ways, one of which is the "income" approach. The *income approach* looks at the value of the property versus the rents the property can produce. While financing does not technically come into the equation, it does affect the property's profitability to the investor. Thus, a property that can be financed at a lower interest rate will be more attractive to the investor if cash flow is a major concern.

Tax Impact of Financing

Down payments made on a property as an investor are not tax-deductible. In fact, a large down payment offers no tax advantage at all because the investor's tax basis is based on the purchase price, not the amount he or she puts down. However, because mortgage interest is a deductible expense, the investor does better tax wise by saving his or her cash. Think about it: the higher the monthly mortgage payment, the less cash flow, the less taxable income each year. While positive cash flow is desirable, it does not necessarily mean that a property is more profitable because it has more cash flow. A larger down payment will obviously increase monthly cash flow, but it is not always the best use of your money.

How Real Estate Investors Use Financing

As discussed above, investors use mortgage loans to increase their leverage. The more money an investor can borrow, the more he or she can leverage the investment. Rarely do investors use all cash to purchase properties, and when they do, it is on a short-term basis. They usually refinance the property to get their cash back or sell the property for cash.

The challenge is that loans for investors are treated as high-risk by lenders when compared to noninvestor (owner-occupied properties) loans. Lenders often look at leveraged investments as risky and are less willing to loan money to investors. Lenders assume (often correctly) that the less of your own money you have invested, the more likely you will be to walk away from a bad property. In addition, fewer investor loan programs mean less competition in the industry, which leads to higher loan costs for the investor. The goal of the investor thus is to put forth as little cash as possible, pay the least amount in loan costs and interest, while keeping personal risk at a minimum. This is quite a challenge, and this book will reveal some of the secrets for accomplishing this task.

When Is Cash Better Than Financing?

Using all cash to purchase a property may be better than financing in two particular situations. The first situation is a short-term deal, that is, you intend to sell the house shortly after you buy it (known as "flipping"). When you have the cash to close quickly, you can generally get a tremendous discount on the price of a house. In this case, financing may delay the transaction long enough to lose an opportunity. Cash also allows you to purchase properties at a larger discount. You've heard the expression, "money talks, BS walks." This is particularly true when making an offer to purchase a property through a real estate agent. The real estate agent is more likely to recommend to his or her client a purchase offer that is not contingent on the buyer obtaining bank financing.

The second case is one in which you can use your retirement account. You can use the cash in your IRA or SEP to purchase real estate, and the income from the property is tax-deferred. In order to do this, you need an aggressive self-directed IRA custodian (oddly enough, most IRA custodians view real estate as "risky" and the stock market as "safe"). Two such custodians are Mid Ohio Securities, <www.midoh.com>, or Entrust Administration, <www.entrustadmin.com>.

Understanding a Cash Offer versus Paying All Cash

If you make a “cash offer” on a property, it does not necessarily mean you are using all of your own cash. It means the seller is receiving all cash, as opposed to the seller financing some part of the purchase price (discussed more fully in Chapter 9).

What to Expect from This Book

This book will show you how to finance properties with as little cash as possible, while maintaining minimum risk and maximum profit.

The first few chapters describe the mortgage loan process, legal details, and the banking industry. Chapter 4 covers different types of lenders and loans, and the benefits of each. Chapter 5 covers how to creatively use institutional loan programs as an investor. Chapters 6, 7, 8, and 9 cover creative, noninstitutional financing.

As with any technique on real estate acquisition or finance, you should review the process with a local professional, including an attorney. Also, keep in mind that while most of these ideas are applicable nationwide, local practices, laws, rules, customs, and market conditions may require variations or adaptations for your particular use.

Key Points

- Interest rates affect property values.
- Financing affects the value of a property to an investor.
- Investors use financing to leverage their investments.

CHAPTER 2

A Legal Primer on Real Estate Loans

If there were no bad people there would be no good lawyers.

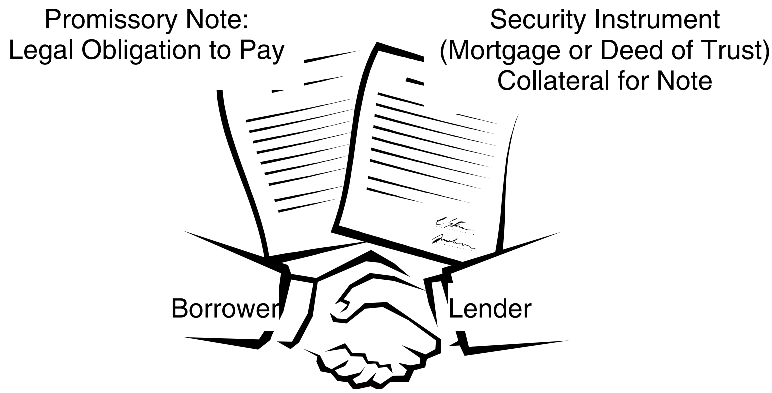
–Charles Dickens

Before we discuss lenders, loans, and loan terms, it is essential that you understand the legal fundamentals and paperwork involved with mortgage loans. By analogy, you cannot make a living buying and selling automobiles without a working knowledge of engines and car titles. Likewise, you need to understand how the paperwork fits into the real estate transaction. Without a working knowledge of the paperwork, you are at the mercy of those who have the knowledge. Furthermore, without the know-how your risk of a large mistake or missed opportunity increases tremendously.

What Is a Mortgage?

Most of us think of going to a bank to get a mortgage. Actually, you go to the bank to get a loan. Once you are approved for the loan, you sign a promissory note to the lender, which is a legal promise to

FIGURE 2.1 The Mortgage Transition



pay. You also give the lender (not get) a mortgage as security for repayment of the note. A *mortgage* (also called a "deed of trust" in some states) is a security agreement under which the borrower pledges his or her property as collateral for payment. The mortgage document is recorded in the county property records, creating a lien on the property in favor of the lender. See Figure 2.1.

If the underlying obligation (the promissory note) is paid off, the lender must release the collateral (the mortgage). The release will remove the mortgage lien from the property. If you search the public records of a particular property, you will see many recorded mortgages that have been placed and released over the years.

Promissory Note in Detail

A note is an IOU or promise to pay; it is a legal obligation. A promissory note (also known as a "note" or "mortgage note") spells out the amount of the loan, the interest to be paid, how and when payments are made, and what happens if the borrower defaults. The note may also contain disclosures and other provisions required by federal or state law.

A Mortgage Note Is a Negotiable Instrument

Like a check, a mortgage note can be assigned and collected by whoever holds the note. As discussed in Chapter 3, mortgage notes are often bought, sold, traded, and hypothecated (pledged as collateral).

Most lenders use a form of note that is approved by the Federal National Mortgage Association (FNMA, or Fannie Mae). A sample form of this note can be found in Appendix C. The note is signed (in legal terms, "executed") by the borrower. The original note is held by the lender until the debt is paid in full, at which time the original note is returned to the borrower marked "paid in full."

A Promissory Note Is a Personal Obligation

Because promissory notes are personal obligations, the history of payments will appear on your credit file, even if the debt is used for investment. If you fail to pay on the note, your credit will be adversely affected, and you risk a lawsuit from the lender. Some notes are nonrecourse, that is, the lender cannot sue you personally. Although not always possible, you should try to make sure most of your debt is nonrecourse.

FIGURE 2.2 Parties to a Mortgage

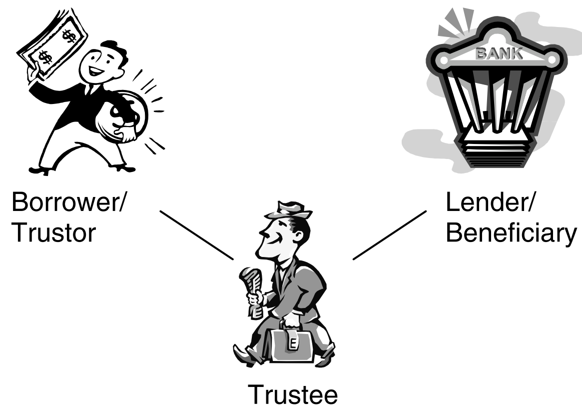
The Mortgage in Detail

The security agreement executed by the borrower pledges the property as collateral for the note. Known by most as a "mortgage," this document, when recorded (discussed below), creates a lien in favor of the lender. The mortgage agreement is generally a standardized form approved by FNMA. While the form of note is generally the same from state to state, the mortgage form differs slightly because the legal process of foreclosure (the lender's right to proceed against the collateral) is different in each state. See Figure 2.2.

The mortgage document will state that upon default of the note, the lender can exercise its right to foreclose on the property. Foreclosure is the process of lenders exercising their legal right to proceed against the collateral for the loan (discussed later in this chapter). It also places other obligations upon the borrower, such as

- maintaining the property,
- paying property taxes, and
- keeping the property insured.

FIGURE 2.3 Parties to a Deed of Trust



The Deed of Trust

Some states (e.g., California) use a document called a "deed of trust" (AKA "trust deed") rather than a mortgage. The *deed of trust* is a document in which the trustor (borrower) gives a deed to the neutral third party (trustee) to hold for the beneficiary (lender). A deed of trust is worded almost exactly the same as a mortgage, except for the names of the parties. Thus, the deed of trust and mortgage are essentially the same, other than the foreclosure process. See Figure 2.3.

The Public Recording System

The recording system gives constructive notice to the public of the transfer of an interest in property. Recording simply involves bringing the original document to the local county courthouse or county clerk's office. The original document is copied onto a computer file or onto microfiche and is returned to the new owner. There is a filing fee of about $6 to $10 per page for recording the document.

In addition, the county, city, and/or state may assess a transfer tax based on either the value of the property or the mortgage amount.

A deed or other conveyance does not have to be recorded to be a valid transfer of an interest. For example, what happens if John gives title to Mary, then he gives it again to Fred, and Fred records first? What happens if John gives a mortgage to ABC Savings and Loan, but the mortgage is not filed for six months, and then John immediately borrows from another lender who records its mortgage first? Who wins and loses in these scenarios?

Most states follow a "race-notice" rule, meaning that the first person to record his document, wins, so long as

- he received title in good faith,
- he paid value, and
- he had no notice of a prior transfer.

☛ **Example:** John buys a home and, in so doing, borrows $75,000 from ABC Savings Bank. John signs a promissory note and a mortgage pledging his home as collateral. Because ABC messes up the paperwork, the mortgage does not get recorded for 18 months. In the interim, John borrows $12,000 from The Money Store, for which he gives a mortgage as collateral. The Money Store records its mortgage, unaware of John's unrecorded first mortgage to ABC. The Money Store will now have a first mortgage on the property.

Priority of Liens

Liens, like deeds, are "first in time, first in line." Thus, if a property is owned free and clear, a mortgage recorded will be a *first mortgage.* A mortgage recorded thereafter will be a *second mortgage* (sometimes called a *junior mortgage* because its lien position is behind the first mortgage). Likewise, any judgments or other liens recorded later are also junior liens. Holding a first mortgage is a desirable position because a foreclosure on a mortgage can wipe out all liens that are recorded behind it (called "junior lien holders"). The process of foreclosure will be discussed in more detail later in this chapter.

At the closing of a typical real estate sale, the seller conveys a deed to the buyer. Most buyers obtain a loan from a conventional lender for most of the cash needed for the purchase price. As discussed earlier, the lender gives the buyer cash to pay the seller, and the buyer gives the lender a promissory note. The buyer also gives the lender a security instrument (mortgage or deed of trust) under which she pledges the property as collateral. When the transaction is complete, the buyer has the title recorded in her name and the lender has a lien recorded on the property.

What Is Foreclosure?

Foreclosure is the legal process of the mortgage holder taking the collateral for a promissory note in default. The process is slightly different from state to state, but there are basically two types of foreclosure: judicial and nonjudicial. In mortgage states, judicial foreclosure is used most often, whereas in deed of trust states, nonjudicial (called power of sale) foreclosure is used. Most states permit both types of proceedings, but it is common practice in most states to exclusively use one method or the other. A complete state-by-state list of foreclosure proceedings can be found in Appendix B.

Judicial Foreclosure

Judicial foreclosure is a lawsuit that the lender (mortgagee) brings against the borrower (mortgagor) to force the sale of the property. About one-third of the states use judicial foreclosure. Like all lawsuits, a judicial foreclosure starts with a summons (a legal notice of the lawsuit) served on the borrower and any other parties with inferior rights in the property. (Remember, all junior liens, including tenancies, are wiped out by the foreclosure, so they all need to be given legal notice of the proceeding.)

If the borrower does not file an answer to the lawsuit, the lender gets a judgment by default. A person is then appointed by the court to compute the total amount due including interest and attorney's fees. The lender then must advertise a notice of sale in the newspaper for several weeks.

If the total amount due is not paid by the sale date, a public sale is held on the courthouse steps. The entire process can take as little as a few months to a year depending on your state and the volume of court cases in your county.

The sale is conducted like an auction, in that the property goes to the highest bidder. Unless there is significant equity in the property, the only bidder at the sale will be a representative of the lender. The lender can bid up to the amount it is owed, without having to actually come out of pocket with cash to purchase the property. Once the lender has ownership of the property, it will try to sell it through a real estate agent.

If the proceeds from the sale are insufficient to satisfy the amount owed to the lender, the lender may be entitled to a deficiency judgment against the borrower and anyone else who guaranteed the loan. Some states prohibit a lender from obtaining a deficiency judgment against a borrower (applies only to owner-occupied, not investor properties). In practice, few lenders seek a deficiency judgment against the borrower.

Nonjudicial Foreclosure

A majority of the states permit a lender to foreclose without a lawsuit, using what is commonly called a "power of sale." Upon default of the borrower, the lender simply files a notice of default and a notice of sale that is published in the newspaper. The entire process generally takes about 90 days.

What Is a Deficiency?

In order for a borrower to be held personally liable for a foreclosure deficiency, there must be recourse on the note. Most loans in the residential market are with recourse. If possible, particularly when dealing with seller-financed loans (see Chapter 9), have a corporate entity sign on the note in your place. A corporation or limited liability company (LLC) protects its business owners from personal liability for business obligations. Upon default, the lender's legal recourse will be against the property or the corporate entity, but not against you, the business owner.

Strict Foreclosure

Two states—New Hampshire and Connecticut—permit strict foreclosure, which does not require a sale. When the court proceeding is started, the borrower has a certain amount of time to pay what is owed. Once that date has passed, title reverts to the lender without the need for a sale.

Key Points

- A mortgage is actually two things—a note and a security instrument.
- Some states use a deed of trust as a security instrument.
- Liens are prioritized by recording date.
- Foreclosure processes differ from state to state.

CHAPTER 3

Understanding the Mortgage Loan Market

Neither a borrower nor a lender be; for loan oft loses both itself and friend.

—William Shakespeare

The mortgage business is a complicated and ever-changing industry. It is important that you understand how the mortgage market works and how the lenders make their profit. In doing so, you will gain an appreciation of loan programs and why certain loans are offered by certain lenders.

There are several categories of lenders that are discussed in this chapter, and many lenders will fit in more than one category. In addition, some categories of lending are more of a lending "style" than a lender category; this concept will make more sense after you finish reading this chapter.

Institutional Lenders

The first broad category of distinction is institutional versus private. Institutional lenders include commercial banks, savings and loans or thrifts, credit unions, mortgage banking companies, pension funds, and insurance companies. These lenders generally make loans based on the income and credit of the borrower, and they generally follow standard lending guidelines. Private lenders are individuals or small companies that do not have insured depositors and are generally not regulated by the federal government.

Primary versus Secondary Mortgage Markets

First, these markets should not be confused with first and second mortgages, which were discussed in Chapter 2. *Primary mortgage lenders* deal directly with the public. They *originate* loans, that is, they lend money directly to the borrower. Often referred to as the "retail" side of the business, lenders make a profit from loan processing fees, not from the interest paid on the loan.

Primary mortgage lenders generally lend money to consumers, then sell the mortgage notes (together in large packages, not one at a time) to investors on the *secondary mortgage market* to replenish their cash reserves.

Portfolio lenders don't sell their loans to the secondary market, but rather they keep the loans as part of their portfolio (some lenders sell part of their loans and keep others as part of their portfolio). As such, they don't necessarily need to conform their loans to guidelines established by the Federal National Mortgage Association (FNMA) or the Federal Home Loan Corporation (FHLMC). Small, local banks that portfolio their loans can be an investor's best friend, because they can bend the rules to suit that investor's needs.

Larger portfolio lenders can handle more loans, because they have more funds, but they are not as flexible as the small banks. Larger portfolio lenders can also give you an unlimited amount of loans, whereas FNMA/FHLMC lenders have limits on the number of loans they can give you (currently loans for nine properties, but these limits often change). The nation's larger portfolio lenders include World Savings and Washington Mutual.

Why Sell the Loan?

Lenders sell loans for a variety of reasons. First, they want to maximize their cash reserves. By law, banks must have a minimum reserve, so if they lend all of their available cash, they can't do any more loans. Second, they want to minimize their risk of interest rate fluctuations in the market.

The largest buyers on the secondary market are FNMA (or "Fannie Mae"), the Government National Mortgage Association (GNMA, or "Ginnie Mae"), and the FHLMC (or "Freddie Mac"). Private financial institutions such as banks, life insurance companies, private investors, and thrift associations also buy notes.

FNMA is a quasi-governmental agency (controlled by the government but owned by private shareholders) that buys pools of mortgage loans in exchange for mortgage-backed securities. GNMA is a division of the Department of Housing and Urban Development (HUD), a governmental agency. Because most loans are sold on the secondary mortgage market to FNMA, GNMA, or FHLMC, most primary mortgage lenders conform their loan documentation to these agencies' guidelines (known as a "conforming" loan). Although primary lenders sell the loans on the secondary mortgage market, many of the primary lenders will continue to collect payments and deal with the borrower, a process called *servicing.*

Mortgage Bankers versus Mortgage Brokers

Many consumers assume that "mortgage companies" are banks that lend their own money. In fact, a company that you deal with may be either a mortgage banker or a mortgage broker.

A *mortgage banker* is a direct lender; it lends you its own money, although it often sells the loan to the secondary market. Mortgage

Loan Servicing

Loan servicing is an immensely profitable business for mortgage banks and other lenders. Servicing involves collecting the loan payments, accounting for tax and insurance escrows, dealing with customer issues, and mailing notices to the customer and the Internal Revenue Service (IRS). The average fee charged for servicing is about ⅜ percent of the loan amount. This may not sound like much, but try multiplying it by a billion dollars!

bankers (also known as "direct lenders") sometimes retain servicing rights as well.

A *mortgage broker* is a middleman who does the loan shopping and analysis for the borrower and puts the lender and borrower together. Many of the lenders through which the broker finds loans do not deal directly with the public (hence the expression "wholesale lender").

Using a mortgage banker can save the fees of a middleman and can make the loan process easier. A mortgage banker can give you direct loan approval, whereas a broker gives you information secondhand. However, many mortgage banks are limited in what they can offer, which is essentially their own product. In addition, if you present your loan application in a poor light, you've already made a bad impression. I am not suggesting you lie or mislead a lender, but understand that presenting a loan to a lender is like presenting your taxes to the IRS. There are many ways to do it, all of which are valid and legal. Using a mortgage broker allows you to present a loan application to a different lender in a different light (and you are a "fresh" face).

A mortgage broker charges a fee for his or her service but has access to a wide variety of loan programs. He or she also may have knowledge of how to present your loan application to different lenders for approval. Some mortgage bankers also broker loans. As an investor, it is wise to have both a mortgage broker and a mortgage banker on your team.

> **Mortgage Brokering**
>
> Keep in mind that mortgage brokering is an unlicensed profession in many states. If there is no licensing agency to complain to in your state, make sure you have personal references before you do business with a mortgage broker.

Conventional versus Nonconventional Loans

Conventional financing, by definition, is not insured or guaranteed by the federal government (see discussion of government loans later in this chapter). Conventional loans are generally broken into two categories: conforming and nonconforming. A *conforming loan* is one that conforms or adheres to strict Fannie Mae/Freddie Mac loan underwriting guidelines.

Conforming Loans

Conforming loans are a low risk to the lender, so they offer the lowest interest rates. Conforming loans also have the strictest underwriting guidelines.

Conforming loans have the following three basic requirements:

1. *Borrower must have a minimum of debt.* Lenders look at the ratio of your monthly debt to income. Your regular monthly expenses (including mortgage payments, property taxes, insurance) should total no more than 25 percent to 28 percent of your gross monthly income (called "front-end ratio"). Further-

> **Underwriting**
>
> Underwriting is the task of applying guidelines that provide standards for determining whether or not a loan should be approved. Understand that loan approval is the final step in the loan application process before the money is handed over (known as "funding" a loan). Note that many lenders will give "preapproval" of a loan. Preapproval is really a half-baked commitment. Until a loan is approved in writing, the bank has no legal commitment to fund. And, in many cases, loan approval is often given with conditions attached that must be satisfied before closing.

more, your monthly expenses plus other long-term debt payments (e.g., student loan, automobile, alimony, child support) should total no more than 36 percent of your gross monthly income (called "back-end ratio"). These ratios can sometimes be increased if the borrower has excellent credit or puts up a larger down payment.

2. *Good credit rating.* You must be current on payments. Lenders will also require a certain minimum credit score (discussed in Chapter 4).

3. *Funds to close.* You must have the requisite down payment (generally 20 percent of the purchase price, although lenders often bend this rule), proof of where it came from, and a few months of cash reserves in the bank.

FHA-insured loans (discussed later in this chapter) allow higher LTVs but are more limited in scope and are not generally available to investors (discussed later in this chapter).

What Is the Loan-to-Value (LTV) Ratio?

Loan-to-value ratio is the percentage of the value of the property the lender is willing to lend. For example, if the property is worth $100,000, an 80 percent LTV loan will be for $80,000. Note that LTV is not the same as loan-to-purchase price, because the purchase price may be more or less than the appraised value (discussed in more detail in Chapter 5).

Private mortgage insurance. Private mortgage insurance (PMI) requirements apply only to first mortgage loans; thus, you can get around PMI requirements by borrowing a first and second mortgage loan. So long as the first mortgage loan is less than 80 percent loan-to-value, PMI is not required. However, the second mortgage loan may have a high interest rate, so that the blending of the interest rate on the first and second mortgage loans exceeds what you would be paying with a first mortgage and PMI. Use a calculator to figure out which is more profitable for you (the formula for interest rate blending is discussed in Chapter 5).

One way around the large down payment is to purchase PMI. Also known as "mortgage guaranty insurance," PMI will cover the lender's additional risk for a high loan-to-value ratio (LTV) program. The insurer will reimburse the lender for its additional risk of the high LTV.

PMI should not be confused with mortgage life insurance, which pays the borrower's loan balance in full when he or she dies (not recommended—regular term life insurance is a better deal for the money).

Nonconforming Loans

Nonconforming loans have no set guidelines and vary widely from lender to lender. In fact, lenders often change their own nonconforming guidelines from month to month.

Nonconforming loans are also known as "subprime" loans, because the target customer (borrower) has credit and/or income verification that is less than perfect. The subprime loans are often rated according to the creditworthiness of the borrower—"A," "B," "C," or "D."

An "A" credit borrower has had few or no credit problems within the past two years, with the exception of a late payment or two with a good explanation. A "C" credit borrower may have a history of several late payments and a bankruptcy.

The subprime loan business has grown enormously over the past ten years, particularly in the refinance business and with investor loans. Every lender has its own criteria for subprime loans, so it is impossible to list every loan program available on the market. Suffice it to say, the guidelines for subprime loans are much more lax than they are for conforming loans.

Government Loan Programs

The federal government and state government sponsor loan programs to encourage home ownership. Most of the loan programs are geared towards low-income neighborhoods and first-time homebuyers. If you are dealing in low-income properties, you should be aware of these guidelines if you intend to sell properties to these target homebuyers. Also, some of these programs are geared to investors as well.

Confusion of Terms

Some mortgage professionals will use the expression "conventional" to mean "conforming," and vice-versa. So, when a mortgage broker says that "you'll have to go with a nonconforming loan," the loan documentation may still have to substantially conform with FNMA guidelines. In fact, even loans that do not conform with FNMA or conventional standards are underwritten on FNMA "paper" (the actual note, mortgage, and other related documents). Lenders do this with the intention of eventually selling the paper, even if it may begin as a portfolio loan.

Federal Housing Administration Loans

HUD is the U.S. Department of Housing and Urban Development, an executive branch of the federal government. The Federal Housing Administration (FHA) is an arm of HUD that administers loan programs. HUD does not lend money but rather insures lenders that make high LTV loans. Because high LTV loans are risky for lenders, the FHA-insured loan programs cover the additional risk. Not all lenders can make FHA-insured loans; they must be approved by HUD.

The most common FHA loan program is the 203(b) program, designed for first-time homebuyers. This program allows an owner-occupant to put just 3 percent down and borrow 97 percent loan-to-value. This program is for owner-occupied (noninvestor) properties, but investors should be familiar with the program because they may wish to sell a property to a buyer who may use the program.

The two most common HUD loans available for investors are the Title 1 Loan and the 203(k) loan.

Title 1 loan. The Title 1 loan insures loans of up to $25,000 for light to moderate rehab of single-family properties, or $12,000 per unit for a maximum of $60,000 on multifamily properties. The interest rates on these loans are generally market rate, although local participation by state or municipal agencies may reduce the rate (see below).

An interesting note on Title 1 loans is that it is not limited to owners of the property. A lessee or equitable owner under an installment land contract (discussed in Chapter 9) may qualify for the loan.

FHA 203(k) loan. The 203(k) program is for an investor who wants to live in the home while rehabbing it. It allows the investor-occupant to borrow money for the purchase or refinance of a home as well as for the rehab costs. It is an excellent alternative to the traditional route for these investors, which is to buy a property with a temporary ("bridge") loan, fix the property, then refinance it (many lenders won't offer attractive, long-term financing on rehab properties).

The 203(k) loan can be for up to the value of the property plus anticipated improvement costs, or 110 percent of the value of the property, whichever is less. The rehab cost must be at least $5,000, but there is no limit to the size of the rehab (although it cannot be used for new construction, that is, the basic foundation of the property must be used, even if the building is razed). The program can be used for condominiums, provided that the condo project is otherwise FHA qualified. Cooperative apartments, popular in New York and California, are not eligible.

The Department of Veterans Affairs

The Department of Veterans Affairs (VA) guarantees certain loan programs for eligible veterans. As an occupant, an eligible veteran can borrow up to 100 percent of the purchase price of the property. When a borrower with a VA-guaranteed loan cannot meet the payments, the lender forecloses on the home. The lender next looks to the VA to cover the loss for its guarantee, and the VA takes ownership of the home. The VA then offers the property for sale to the public.

Condominium Financing Pitfalls

Condominiums can be difficult to finance in general, as compared to single-family homes. In general, stay away from units in developments that have a large concentration of investor-owners. Condo developments that have a 50 percent or more concentration of nonoccupant owners are very difficult to finance through institutional lenders.

State and Local Loan Programs

Many states and localities sponsor programs to help first-time homebuyers qualify for mortgage loans. The programs are aimed at improving low-income neighborhoods by increasing the number of owners versus renters in the area. Most of these programs are for owner-occupants, not investors, but it may also help to know about these programs when you are selling homes.

Some state and local programs work in conjunction with HUD programs, such as Title 1 loans. Contact your state or city department of housing for more information on locally sponsored loan programs. A list of links to state programs can be found at <www.hsh.com/pamphlets/state_hfas.html>.

Commercial Lenders

Most of the discussion so far has been about financing of single-family homes and small multifamily residential homes. What about large multifamily projects and commercial projects, such as shopping centers, strip malls, and office buildings? Many of the same concepts do apply, except for the financing guidelines.

Commercial lenders generally do not have industry-wide loan criteria. Instead, each lender has its own criteria and will review loans on a project-by-project basis. Lenders will look at the experience of the investor as well as the income and expenses of the particular collateral. In other words, commercial lenders are more concerned with whether the property will generate enough income to pay the loan, not whether the borrower has good credit (although a borrower with poor credit will generally have a hard time getting any type of loan from an institutional lender). A commercial appraisal is required, which is more detailed and expensive than a residential appraisal. A commercial loan will require the borrower to have a substantial reserve of cash to handle vacancies.

Commercial loans also can be made for residential buildings of five units or more, but there is a minimum loan amount required by each lender (generally a $300,000 to $500,000, depending on the property values in your marketplace). Oddly enough, multimillion dollar loans are often made without recourse to the borrower. In other words, if the project fails, the borrower (often a corporate entity) is not liable for the debt. The lender's sole recourse is to foreclose against the property. For this reason, the lender is more concerned with the property than the borrower.

Key Points

- Most lenders sell their loans to the secondary market.
- Loans come in three basic categories: conforming, nonconforming, and government.
- The government does not lend money, but rather it guarantees loans.
- Commercial lenders look to the property rather than the borrower.

CHAPTER 4

Working with Lenders

Except for the con men borrowing money they shouldn't get and the widows who have to visit with the handsome young men in the trust department, no sane person ever enjoyed visiting a bank.

—Martin Meyer

Now that you understand how loans and the mortgage market works, you can begin to understand how to approach financing. In Chapter 3, we discussed a variety of loan *programs* that differ based on the lender, the type of property, and the borrower. We will now turn to loan *types* that are generally available in most of the loan programs discussed thus far and the advantages and disadvantages of each. Before doing so, let's explore some of the relevant issues we need to consider when borrowing money.

Interest Rate

The cost of borrowing money, that is, the interest rate, is one of the most important factors. As discussed in Chapter 1, interest rates affect monthly payments, which in turn affect how much you can afford to pay for a property. It may also affect cash flow, which affects your decision to hold or sell property.

Loan Amortization

There are many different ways a loan can be structured as far as interest payments go. The most common ways are simple interest and amortized.

As discussed in Chapter 1, a simple interest loan is calculated by multiplying the loan balance by the interest rate. So, for example, a $100,000 loan at 12 percent interest would be $12,000 per year, or $1,000 per month. The payments here, of course, represent interest-only, so the principal amount of the loan does not change.

An amortized loan is slightly more involved. The actual mathematical formula is beyond a book like this, so we've provided a sample interest rate table in Appendix A. However, you can find a thousand Internet Web sites that will do the calculations instantly online (try mine at <www.legalwiz.com>—click on "calculators"). The amortization method breaks down payments over a number of years, with the payment remaining constant each month. However, the interest is calculated on the remaining balance, so the amount of each monthly payment that accounts for principal and interest changes. For the most part, the more payments you make, the more you decrease the amount of principal owed (the amount of the loan still left to pay). See Figure 4.1.

The loan *term* or duration is important to figuring your payment. By custom, most loans are amortized over 30 years or 360 monthly payments. The second most common loan term is 15 years. The payments on a 15-year amortization are higher each month, but you pay the loan off faster and thus pay less interest in the long run.

FIGURE 4.1 Amortization of $100,000 Loan at 8% Interest Over 30 Years

Payment #	Date	Payment	Interest	Principal	Loan Balance
1	02-01-2003	733.76	666.67	67.09	99,932.91
2	03-01-2003	733.76	666.22	67.54	99,865.37
3	04-01-2003	733.76	665.77	67.99	99,797.38
4	05-01-2003	733.76	665.32	68.44	99,728.94
5	06-01-2003	733.76	664.86	68.90	99,660.04
6	07-01-2003	733.76	664.40	69.36	99,590.68
7	08-01-2003	733.76	663.94	69.82	99,520.86
8	09-01-2003	733.76	663.47	70.29	99,450.57
9	10-01-2003	733.76	663.00	70.76	99,379.81
10	11-01-2003	733.76	662.53	71.23	99,308.58
11	12-01-2003	733.76	662.06	71.70	99,236.88
12	01-01-2004	733.76	661.58	72.18	99,164.70
13	02-01-2004	733.76	661.10	72.66	99,092.04
14	03-01-2004	733.76	660.61	73.15	99,018.89
15	04-01-2004	733.76	660.13	73.63	98,945.26
16	05-01-2004	733.76	659.64	74.12	99,871.14
17	06-01-2004	733.76	659.14	74.62	98,796.52
18	07-01-2004	733.76	658.64	75.12	98,721.40
19	08-01-2004	733.76	658.14	75.62	98,645.78
20	09-01-2004	733.76	657.64	76.12	98,569.66
21	10-01-2004	733.76	657.13	76.63	98,493.03
22	11-01-2004	733.76	656.62	77.14	98,415.89
23	12-01-2004	733.76	656.11	77.65	98,338.24
24	01-01-2005	733.76	655.59	78.17	98,260.07
25	02-01-2005	733.76	655.07	78.69	98,181.18
26	03-01-2005	733.76	654.54	79.22	98,102.16
27	04-01-2005	733.76	654.01	79.75	98,022.41
28	05-01-2005	733.76	653.48	80.28	97,942.13
29	06-01-2005	733.76	652.95	80.81	97,861.32
30	07-01-2005	733.76	652.41	81.35	97,779.97
31	08-01-2005	733.76	651.87	81.89	97,698.08
32	09-01-2005	733.76	651.32	82.44	97,615.64
33	10-01-2005	733.76	650.77	82.99	97,532.65
34	11-01-2005	733.76	650.22	83.54	97,449.11
35	12-01-2005	733.76	649.66	84.10	97,365.01
36	01-01-2006	733.76	649.10	84.66	97,280.35
37	02-01-2006	733.76	648.54	85.22	97,195.13
38	03-01-2006	733.76	647.97	85.79	97,109.34
39	04-01-2006	733.76	647.40	86.36	97,022.98
40	05-01-2006	733.76	646.82	86.94	96,936.04
41	06-01-2006	733.76	646.24	87.52	96,848.52
42	07-01-2006	733.76	645.66	88.10	96,760.42
43	08-01-2006	733.76	645.07	88.69	96,671.73
44	09-01-2006	733.76	644.48	89.28	96,582.45
45	10-01-2006	733.76	643.88	89.88	96,492.57
46	11-01-2006	733.76	643.28	90.48	96,402.09
349	02-01-2032	733.76	56.28	677.48	7,764.01
350	03-01-2032	733.76	51.76	682.00	7,082.01
351	04-01-2032	733.76	47.21	686.55	6,395.46
352	05-01-2032	733.76	42.64	691.12	5,704.34
353	06-01-2032	733.76	38.03	695.73	5,008.61
354	07-01-2032	733.76	33.39	700.37	4,308.24
355	08-01-2032	733.76	28.72	705.04	3,603.20
356	09-01-2032	733.76	24.02	709.74	2,893.46
357	10-01-2032	733.76	19.29	714,47	2,178.99
358	11-01-2032	733.76	14.53	719.23	1,459.76
359	12-01-2032	733.76	9.73	724.03	735.73

15-Year Amortization versus 30-Year Amortization

In general, 15-year loans tend to have a slightly lower interest rate. In addition, you reach your financial goal of “free and clear” faster. However, there are three downsides to the 15-year loan. The first is that you are obligated to a higher payment that reduces your cash flow. Second, the higher monthly obligation appears on your credit report, which affects your debt ratios and thus your ability to borrow more money (discussed later in this chapter). Third, your monthly payment is less interest and more principal. While this may sound like a good thing, it doesn’t give you the same tax benefits; interest payments are deductible, principal payments are not.

Three Negatives to a 15-Year Loan

1. Higher monthly payments
2. Increased debt ratios
3. Less of a tax deduction

Unless the interest rate on the 15-year note is significantly lower, opt for the 30-year note. You can accomplish the faster principal pay down by making extra interest payments to the lender.

☛ **Example:** On a $100,000 loan amortized at 8% over 30 years, your payment is $733.76. If you make an additional principal payment each month of $100, the loan would be fully amortized in just over 20 years, saving you $62,468.87 in interest.

You can use a financial calculator to calculate how much extra you need to pay each month to reduce the loan term (again, try mine at <www.legalwiz.com>—click on “calculators”). And, of course, when times are hard and the property is vacant, you aren't obligated to make the higher payment.

Biweekly Mortgage Payment Programs

An entire multilevel marketing business has been made out of the selling people the idea of a biweekly mortgage program. Basically, if you pay your loan every two weeks rather than monthly, you make two extra payments per year. With the additional payments going towards principal, the debt amortizes faster. Before plunking down several hundred dollars to a third party to do this for you, ask your lender. Many lenders will set up a direct deposit program from your bank account for biweekly payments.

Balloon Mortgage

A *balloon* is a premature end to a loan's life. For example, a loan could call for interest-only payments for three years, then be due in full at the end of three years. Or, a loan could be amortized over 30 years, with the principal balance remaining due in five years. When the loan balloon payment becomes due, the borrower must pay the full amount or face foreclosure.

A balloon provision can be risky for the borrower, but if used with common sense, it may work effectively by satisfying the lender's needs. Balloon notes are often used by builders as a short-term financing tool. These types of loans are also known as "bridge" or "mezzanine" financing.

Reverse Amortization

Regular amortization means as you make payments the loan balance decreases. Reverse amortization means the more you pay, the more you owe. How is that possible? Simple—by making a lower payment each month than would be possible for the stated interest rate. A reverse amortization loan increases your cash flow but also increases your risk because you will owe more in the future. If you bought the property below market, a reverse amortization loan may make sense, especially if real estate prices are rising rapidly (another option may be a variable rate loan, discussed later in this chapter).

> **Reverse Amortization Loans for the Elderly**
>
> Many mortgage banks are advertising reverse amortization loans to elderly homeowners as a way to reduce their monthly payments. These loan programs are not intended for investors as described above.

Property Taxes and Insurance Escrows

In addition to monthly principal and interest payments on your loan, you'll have to figure on paying property taxes and hazard insurance. Many lenders won't trust you to make these payments on your own, especially if you are borrowing at a high loan-to-value (80 percent LTV or higher). Lenders estimate the annual payments for taxes and insurance, then collect these payments from you monthly into a reserve account (called an "escrow" or "impound account"). The lender then makes the disbursements directly to the county tax collector and your insurance company on an annual basis. Thus, the total amount collected each month consists of principal and interest payments on the note, plus taxes and insurance—hence the acronym PITI.

Loan Costs

Origination Fee

The cost of a loan is as important as the interest rate. Lenders and mortgage brokers charge various fees for giving you a loan (and you thought they just made money on the interest rates!). Traditionally, the most expensive part of the loan package is the loan origination fee. The fee is expressed in *points,* that is, a percentage of the loan amount: 1 point = 1 percent. So, for example, if a lender charges a "1 point origination fee" on a $100,000 loan, you would pay 1 percent, or $1,000, as a fee.

Discount Points

Another built-in profit center is the charging of "discount points." The lender will offer you a lower interest rate for the payment of money up front. Thus, if you want your interest rate to be lower, you can "buy down" the rate by paying ½ point (percent) or more of the loan up front. Buying down the rate only makes sense if you plan on keeping the loan for a long time; otherwise buying down the interest rate is a waste of money.

Borrowers nowadays are smarter and try to beat the banks at their own game by refusing to pay points. Banks even advertise "no cost" loans, that is, loans with no discount points or origination fees.

Yield Spread Premiums: The Little Secret Your Lender Doesn't Want You to Know

The lower the interest rate, the better off you are, or are you? Lenders advertise "wholesale" interest rates on a daily basis to mortgage brokers, who then advertise rates to their customers. This wholesale interest rate can be marked up on the retail side by the mortgage broker.

☛ **Example:** Say, for example, your mortgage broker offers you an interest rate of 7.25% on a $200,000, 30-year fixed loan. The monthly payment on this loan would be $1,364.35, which is acceptable to you. However, the wholesale rate offered by the lender may be 7.00%, which is $1,330.60 per month. This difference may not seem like much, but over 30 years, it amounts to about $12,000 in additional interest paid. The mortgage broker receives a "bonus" back from the lender for the additional interest earned. This bonus is called a yield spread premium (YSP) because it represents the additional yield earned by the lender for the higher interest rate.

Are Yield Spread Premiums Legal?

At this time,YSPs are legal as long as they are disclosed on the loan documents. Although it is not technically a fee to the borrower, YSPs are not illegal "kickbacks" to the mortgage broker either. You will, however, see the fee noted on the HUD-1 closing statement as POC (paid outside of closing).

Loan Junk Fees

Even without points and at par (no markup on the interest rate), there is no such thing as a no-cost loan. Lenders sneak in their profit by disguising other fees, such as the following:

- Administrative Review
- Underwriting Charge
- Documentation Fee

These charges are given fancy names but are really just ways for the lender to make more profit. Lenders also pad their actual fees, such as the cost of obtaining credit reports, courier charges, and other "miscellaneous fees" (one lender admitted to me that he pays less than $15 for a credit report yet charges the borrower $85!). Understand that lenders are in business to make money, so if a loan sounds too good to be true, it probably is—look carefully at their fees and charges.

Good Faith Estimate

By law, a lender is required to give you a list of the loan fees up front when you apply for the loan. Unscrupulous lenders are notorious for adding in last-minute charges and fees that you won't discover until closing. Of course, you are free to back out at that point, but who wants to lose a good real estate deal? Lenders know this reality, so make sure you get as much as you can in writing before closing the loan.

"Standard" Loan Costs

While every lender has its own fees and points it charges, there are certain costs you can expect to pay with every loan transaction. These fees should be listed in the lender's good faith estimate as well as on the second page of the closing statement. The closing statement is prepared at closing by the escrow agent on a form known as a HUD-1, in compliance with the Real Estate Settlement Procedures Act (RESPA), a federal law. A sample of this form can be found in Appendix C. All of the following charges appear on page two of the form:

- *Title insurance policy.* While a lender secures its loan with a security instrument recorded against the property, it wants a guarantee that its lien is in first position (or, in the case of a second mortgage, second position). A lender's policy of title insurance guarantees to the lender it is in first position (or, in the case of a second mortgage, second position). This policy costs anywhere from a few hundred dollars to a thousand dollars, depending on the amount of the loan and when the last time a title insurance policy was issued on the property; the more recently another policy was issued, the cheaper the policy. Also, if you are purchasing an owner's title insurance policy in conjunction with the lender's policy (very common), the fee for the lender's policy is substantially reduced.

- *Prepaid interest.* While this is not a "fee," it is a cost of financing you pay up front. Because interest is paid for the use of money the month before, you need to figure on paying prorated interest. For example, let's assume your monthly payment on the mortgage note will be $1,000. If you close your loan on the 15th of the month, your first payment won't be due for 45 days. The lender will collect 15 days of interest at closing for the use of the money that month, which is $500.

- *Application fee.* While standard among some lenders, this fee is really a "junk" fee. Nobody should charge you for asking you to do business with them. Lenders often waive this fee if they fund your loan.

- *Document recording fees.* Because the mortgage or deed of trust will be recorded at the county, there are fees charged. The usual range is about $5 to $10 per page, and the typical FNMA Mortgage or deed of trust is anywhere from 12 to 20 pages. In addition, some states and localities (e.g., New York) charge an additional tax on mortgage transactions based on the amount of the loan.

- *Reserves.* If the lender is escrowing property taxes and insurance, it will generally collect a few months extra up front. While technically not a cost, it is cash out of your pocket.

- *Closing fee.* The lender, company, attorney, or escrow company that closes the loan charges a fee for doing so. Closing a loan involves preparing a closing statement, accounting for the monies, and passing around the papers. The closer actually sits down with the borrower and explains the documents and, in most cases, takes a notary's acknowledgment of the borrower (a mortgage or deed of trust must be executed before a notary in order for it to be accepted for recording in public records; the promissory note is not recorded but held by the lender until it is paid in full). The closer also makes sure the documents find their way back to the lender or the county for recording.
- *Appraisal.* Virtually all loans require an appraisal to verify value. An appraisal will cost you between $300 and $500, and even more if the subject property is a multiunit or commercial building. Appraisers often charge additional fees for a "rent survey," which is a sampling of rent payments of similar properties. The lender will want this information to verify that the property can sustain the income you projected.
- *Credit report.* Lenders charge a fee for running your credit report. The lender may charge as much as $85 for a full credit report. Vendors often run short-form credit reports, which are much cheaper. The lender may run a short-form version first to get a quick look at your credit, then a full report at a later time (called a "three bureau merge" because it contains information from the three major credit bureaus).
- *Survey.* A lender may require that a survey be done of the property. A *survey* is a drawing that shows where the property lies in relation to the nearest streets or landmarks. It will also show where the buildings and improvements on the property sit in relation to the boundaries. If a recent survey was performed, it may not be necessary to do a new survey. Rather, the lender may ask for a survey update from the same surveyor or another surveyor. In some parts of the country, an "Improvement Location Certificate" is used; it is essentially a drive-by survey.

- *Document preparation fees.* Some lenders will charge you an attorney's fee for document preparation. Larger lenders have in-house attorneys and paralegals. Smaller lenders hire outside service companies to prepare the loan documents. The reason documents are not always done "in house" is because of the complexities of compliance with lending regulations. Document preparation companies pay lawyers to research the laws and draft documents for compliance. Based on the information provided by the lender, the document preparation company prepares the forms for the lender. The fee for this service is generally a few hundred dollars, which is passed on to the borrower.

Now that you know how lenders make their money, you can negotiate your loan with confidence. Virtually every fee a lender asks for can be negotiated. However, don't expect the lender to waive every fee, charge no points, and get no back-end fees (yield spread premiums). The lender has to make a profit to be willing to do business with you. Profit is also important to you as an investor, but so is the availability of the money you borrow. If you want a lender that is willing to work hard for you, make sure you are willing to pay reasonable compensation. Pinching pennies with your lender will not get it excited about pushing your loan through the process faster. However, knowing what fees are negotiable will allow you to get a loan at a fair interest rate and pay a reasonable fee to get it.

Risk

In addition to profit and cash flow, one of the major factors you should consider in borrowing money is risk. While maximum leverage is important to the investor, it is also higher risk to the investor. The more money you borrow, the more risk you could potentially incur. That is, while you have less investment to lose, you may be personally liable for the debt you have incurred.

With larger commercial projects, the lender's main concern is the financial viability of the project itself. In that case, the borrower does not necessarily have to sign personally on the promissory note. The lender's sole legal recourse is to foreclose the property.

With smaller residential loans, the investor/borrower signs personally on the note and is thus liable personally for the obligation. While the lender can foreclose the property, there may be a deficiency owed that is the personal obligation of the borrower. In the late 1980s, many leveraged investors learned this lesson the hard way when they were forced to file for bankruptcy protection. A smart investor finances properties with a cash cushion, positive (or at least breakeven) cash flow, and at a reasonable loan-to-value ratio.

Nothing Down

While "nothing-down" financing is viable, it does not necessarily mean a 100 percent loan-to-value. For example, buying a $150,000 property for $150,000 with all borrowed money is not a bad deal if the property is worth $200,000. That's a 75 percent LTV. Buying a property for close to 100 percent of its value and financing it 100 percent with personal recourse is very risky. If you don't have the means to support the payments while the property is vacant, you may be in for trouble. Like any business, real estate is about maintaining cash flow.

So, in considering your loan, factor in the following issues:

- Are you near the top of an inflated market?
- Is the local economy's outlook good or bad?
- If purchasing, are you buying below market?
- How long do you intend to hold the property and for what purposes?
- Are prices likely to drop before you sell it?
- Will you be able to refinance the property in the future?

- Are you personally obligated on the note, or is the debt nonrecourse (or signed for by your corporate entity)?

All of these factors are relevant to risk and to whether you want to leverage yourself without a backup plan.

Loan Types

In Chapter 3, we discussed broad categories of loans, such as conventional versus government loans, conforming versus nonconforming loans, brokered loans versus portfolio loans, etc. These distinctions are really lending "styles" more than loan types. Virtually every lender or loan category involves variation of the loan term and interest rate. The loan term is the length of time by which the loan is amortized. The loan term is fixed, whereas the interest rate can vary throughout the term of the loan. Each loan type (fixed versus variable interest rate, 15-year versus 30-year) has a place for the borrower/investor, and we will explore the benefits and detriments of each.

The most common type of real estate loan is a fixed-rate, 30-year amortization. A fixed-rate loan is desirable because it provides certainty. It hedges your bet against higher interest rates by allowing you to lock in a low interest rate. If interest rates fall, you can always refinance at a lower rate at a later time.

With interest rates uncertain in the future, many lenders are offering variable-rate financing. Known as an adjustable-rate mortgage (ARM), there are dozens of variations to suit the lender's profit motives and borrower's needs.

ARMs have two limits, or caps, on the rate increase. One cap regulates the limit on interest rate increases over the life of the loan; the other limits the amount the interest rate can be increased at a time. For example, if the initial rate is 6 percent, it may have a lifetime cap of 11 percent and a one-time cap of 2 percent. The adjustments are made monthly, every six months, once a year, or once every few years, depending on the "index" on which the ARM is based. An index is an outside source that can be determined by formulas, such as the following:

- LIBOR (London Interbank Offered Rate)—based on the interest rate at which international banks lend and borrow funds in the London Interbank market.
- COFI (Cost of Funds Index)—based on the 11th District's Federal Home Loan Bank of San Francisco. These loans often adjust on a monthly basis, which can make bookkeeping a real headache!
- T-bills Index—based on average rates the Federal government pays on U.S. treasury bills. Also known as the Treasury Constant Maturity, or TCM.
- CD Index (certificate of deposit)—based on average rates banks are paying on six-month CDs.

The index you choose will affect how long your rate is fixed for and the chances that your interest rate will increase. Which one is best? Because that depends on what is going on in the national and world economy, you have to review your short-term and long-term goals with your lender before choosing an index.

ARMs are very common in the subprime market and with portfolio lenders, but they can be very risky because of the uncertainty of future interest rates. However, like a balloon mortgage, an ARM can be used effectively with a little common sense. If you plan to sell or refinance the property within a few years, then an ARM may make sense.

Hybrid ARM

Ask your lender about a hybrid ARM, that is, an ARM that is fixed for a period of three, five, or even seven years. After that time, the rate will adjust, usually once (hence the expression "3/1 ARM" or "5/1 ARM"). The initial rates on these loans are not as good as a six-month ARM but will give you more flexibility and certainty (generally, the longer the rate is fixed for, the higher interest rate you'll pay). Also, watch for prepayment penalties that are often built into ARM loans.

For more information on ARM loans, you can download the official consumer pamphlet prepared by the Federal Reserve Board and the Office of Thrift Supervision at my Web site, <www.legalwiz.com/arm>.

Choosing a Lender

Choosing a lender that you want to work with involves several factors, not the least of which is an open mind. You need a lender that can bend the rules a little when you need it and get the job done on a deadline. You need a lender that is large enough to have pull, but small enough to give you personal attention. And, most of all, you need a lender that can deliver what it promises.

Prepayment Penalties

Lenders are smart investors, too. If interest rates are falling, lenders don't want you to pay off a higher interest rate loan. They discourage you from refinancing by adding a prepayment penalty (PPP) clause to your loan. The PPP provision states that if you pay the loan in full within a certain time period (usually within one year to three years), you must pay a penalty. The common penalty ranges from 1 percent to 6 percent of the original loan balance. Make sure that your loan does not have a PPP if you plan on refinancing or selling the property in the next few years.

Length of Time in Business

Because the mortgage brokering business is not highly regulated in most states, there are a lot of fly-by-night operations. Bad news travels faster than good news in business, so bad mortgage brokers don't last too long. Look for a company that has been in business for a few years. Check out the company's history with your local better business bureau. If mortgage brokers are licensed with your state, check to see if any complaints or investigations were made against them.

Also, ask for referrals from other investors and real estate agents. Many mortgage brokers will bait you with "too good to be true" loan programs that most investors won't qualify for. Once they have you hooked, it may be too late to switch brokers, and now you are forced to take whatever loan they can find for you. It's not that all of these mortgage brokers are crooks; it's often the case that the broker is just not knowledgeable about the particular loan programs they offer. In many cases, the particular lender they were dealing with was the culprit. Many wholesale lenders offer programs to mortgage brokers, then when the loan comes through, the underwriter changes its mind or asks for more documentation. In some cases, it is the old bait and switch; in other cases, it is simply a miscommunication between the wholesale lender and the mortgage broker. Thus, it is important that you ask the mortgage broker if it has dealt with the particular lender or loan program in the past.

Company Size

A company that is too big can be problematic because of high employee turnaround. Also, the proverbial "buck" gets passed around a lot. If you are dealing with a mortgage broker, it is often a one-person operation. Dealing with a one-man operation may be good in terms of communication if he or she is a go-getter. On the other hand, the individual may be hard to get a hold of, because he or she is answering the phone all day.

A small to midsized company is a good bet. You will be able to get the boss on the phone, but he or she will have a good support staff to handle the minor details. Also, a midsized company may have access to more wholesale lenders than a one-person company.

Experience in Investment Properties

It is important to deal with a mortgage broker or banker that has experience with investor loans. Owner-occupant loans are entirely different than investor loans. And, it is important that the broker or lender you are dealing with has a number of different programs. It is often the case that you find out a particular loan program won't work, in which case you need to switch lenders (or loan programs) in a heartbeat to meet a funding deadline.

Six Questions to Ask Your Lender

1. How many regular investor clients do you have?
2. Do you get any back-end fees from the lender?
3. What percentage of your loans don't get funded (completed)?
4. What kind of special nonconforming loan programs do you have for investors?
5. What income and credit requirements do I need?
6. What documentation will I need to supply you with?

How to Present the Deal to a Lender

For the most part, lenders follow guidelines established by FNMA and Freddie Mac, as well as their own lending guidelines. If you are looking for the best interest rate, then you must be able to conform to FNMA guidelines, which include a high credit score, provable income, and verifiable assets.

If you are not going with a conforming loan, then there are the following basic guidelines a lender will look at:

- Your credit score
- Your provable income
- The property itself
- Your down payment

Your Credit Score

Much of the institutional loan industry is driven by credit. While having spotless credit is not a necessity, it is certainly a good asset, if used wisely.

Your credit history is maintained primarily by three large companies, known as the credit bureaus: Equifax, TransUnion, and Experian (formerly TRW). Your credit report has "headers" that contain information about your addresses (every one they can find), phone numbers (even the unlisted ones), employer, Social Security number, aliases, and date of birth. This information is usually reported by banks and credit card companies that report to the credit bureaus (be careful about giving your unlisted address or phone number to your credit card company—it may end up on your credit file). Some information comes from public records, such as court filings and property records.

Your credit report also contains a history of nearly every charge card, loan, or other extension of credit that you ever had. It will show the type of loan (e.g., installment loan or revolving credit), the maximum you can borrow on the account, a history of payments, and the amount you currently owe. It will also show information from public records, such as judgments, IRS liens, and bankruptcy filings. Some debts are reported by collection agencies, such as unpaid phone, utility, and cable TV bills. Your credit report will also show every company that pulled your credit report within the past two years (called an "inquiry").

How long does information stay on my credit report? In theory, information stays on your credit report indefinitely. However, federal law—the Fair Credit Reporting Act (FCRA)—requires that any negative remarks be removed upon request after seven years (except for bankruptcy filing, which may remain for ten years). If you don't ask, however, negative information won't always go away.

How do I get negative information removed from my credit report? You may find some information on your report that is just plain wrong. Accounts that are not yours, judgments against people with similar names, and duplicate items are very common. Some items are more subtle, such as the fact that a debt is listed as still unpaid when in fact is was discharged in your bankruptcy. Ask the credit bureau in writing to reinvestigate the information. Under federal law, the bureau must reinvestigate and report back within 30 days. In some states, the law requires a shorter time period. If the bureau does not report back within the requisite time period, the item must be removed.

Communicating with Credit Bureaus

Send your letter by certified mail, return receipt requested. If you do not get results within the time period specified by your state law or the FCRA, you can write a sterner letter threatening to sue under state or federal law. You can also try to contact the creditor directly. Keep in mind that a creditor may also be liable for reporting wrong information. Before jumping into court, try contacting your regional Federal Trade Commission office and your state Attorney General's Consumer Fraud Department.

If you have "bad" items on your credit report, such as late payments, charge-offs, judgments, or a bankruptcy, the credit bureaus can legally report this information. However, if the information is stated in an incorrect or misleading format, you can still ask the bureaus to reinvestigate the information. Sometimes you will get lucky and the bureau does not report back within the required time period. In this event, the information must be removed.

Disputing Items on Your Credit Report

Do not be too specific with your request. For example, if a bureau reports that you had a judgment against you and it was paid, do not volunteer that information (a record of a judgment rendered and paid off is still worse than no judgment in the first place). Simply state that the information is incomplete and request that it be reinvestigated. In some cases, it is less work for the credit bureau to remove the item than to recheck it.

What things affect my credit? Credit reports are based on a computer model, called a FICO score, developed by Fair Isaac, and Co. (FICO, www.fairisaac.com). Although the FICO formula is not generally known to the public, certain things tend to improve your score, such as the following:

- Installment loans (e.g., home mortgage, automobile) that are paid on time
- A few open credit lines with low balances
- A history of living at the same address
- Owning a home

Beyond the obvious late payments, judgments, and bankruptcy, there are certain subtle things that lower your score, such as the following:

- Too many revolving credit card accounts
- Too many inquiries
- High balances on credit cards
- Too many recently-opened accounts

How can I improve my credit? A good credit score is generally above 660. Some loans are so stringent that they require a FICO score above 700. If your score is above 700, you have excellent credit. The bad news is, if you keep borrowing, your score will fall, even if you are current on all payments. So, in short, use your credit wisely. You can check your own FICO score at <www.fairisaac.com>.

If you do not have late payments but want to improve your credit score, you should

- stay away from multiple department store cards—too many open accounts;
- bring a copy of your credit report when shopping for a loan—car dealers may run your credit a dozen times in one day of shopping, leaving damaging "inquiries."
- separate your credit file from your spouse's and remove each other's names from your credit cards; if you have authorization to use your spouse's card, it ends up on your credit file, too.

Can I get a loan with bad credit? Whether you can get a loan with poor credit depends on the type of loan. Unsecured loans, such as credit cards and bank signature loans, usually require a good credit history. Secured loans, such as home mortgages and car loans, are a bit more flexible. Lenders are more aggressive and will take larger risks when the loan is secured by collateral. The lender may require a larger down payment and charge a higher interest rate for the risk of lending to an individual with poor credit.

"I Don't Like Credit Cards—Should I Pay Them Off and Cancel Them?"

Never pay off completely or cancel a credit card! A person with no credit at all is worse off than a person with a bad credit history. You may think that credit cards are evil, but you may not be able to get a phone, a job, or even a utility account without a credit score. A person with an empty credit file looks somewhere between "suspicious" and "scary" to a company inquiring about your credit. Have a credit card or two, and use them once or twice a year, even if it is just to pay to fill up your gas tank.

Your Provable Income

FNMA loan regulations require proof of requisite income to support the loan payments. Proof of income requires strict documentation, such as

- two years of W-2 forms,
- past two pay stubs, and
- two years of tax returns.

If you are self-employed, or at least a 25 percent owner of a business, you need to show that you have been in business at least two years. Proof of self-employment requires copies of tax returns showing the business income.

The Property

An understated point thus far is the property itself. Part of the lender's risk analysis is the property they are collateralizing with the loan. The lender has to keep in the back of its mind the worst-case scenario: a borrower's default and ensuing foreclosure. In other words, the lender asks itself, "Would I want to own this property?"

The appraisal. The first thing a lender will do is order an appraisal. Some lenders have in-house staff, but most use independent contractors. Because the appraiser charges his or her fee whether or not the loan is approved, the lender generally collects the appraisal fee (about $350) from the borrower up front.

There are three generally accepted approaches to appraising property: the market data approach, the cost approach, and the income approach.

Market data approach. The market data approach is the most commonly used formula for single-family homes, condominiums, and small apartments. Basically, a licensed appraiser looks at the three most "similar" houses in the vicinity that have sold recently. He or she then compares square footage and other attributes. The number of bedrooms and baths, age of the property, improvements, physical condition, and the presence of a garage will affect the price, but square footage is usually the most important factor. As you might expect, there are exceptions to this rule. For example, the style of house, its location, and proximity to main roads, and whether it has a view or beach access will greatly affect the value. For the most part, however, if you leave these issues aside, square footage, number of bedrooms and baths, and physical condition are the most relevant factors. Keep in mind that bedrooms and baths on the main level add more value than bedrooms and baths in a basement or attic.

The income approach. With income properties, an appraiser will also use the income approach method, particularly if comparable properties are not available for comparison. The income approach is basically a mathematical formula based on certain presumptions in the marketplace (based, of course, on opinion). The formula is as follows:

Value = Net operating income ÷ Capitalization rate

Net operating income is the potential (not actual) rents the property will command, less average vacancy allowance and operating expenses. Operating expenses include property management, insurance, property taxes, utilities, maintenance, and the like, but not mortgage loan payments.

Capitalization rate is a little more subjective and difficult to calculate. Capitalization, or "cap" rate, is the rate of return a particular investor would expect to receive if he or she purchased a similar property at a similar price. The cap rate is derived from looking at similar properties and the net operating income associated with them. Obviously, estimating cap rate is not an exact science but a trained guess.

Gross rent multiplier. For single-family rentals, duplexes, and other small projects, an appraiser may use the "gross rent multiplier" to help determine value. This formula basically looks at similar properties and their rental incomes. By dividing the sales prices of similar properties by the monthly rent received, the appraiser can come up with a rough formula to compare with the subject property.

Loan-to-Value

Loan-to-value (LTV) is an important criterion in determining the lender's risk. In maximizing leverage, the investor wants to invest as little cash as possible. However, the lender's point of view is that the more equity in the property, the less of a loss it would take if it had to foreclose.

FNMA-conforming loan guidelines generally require an investor to put 20 percent cash down on a purchase, which means an 80 percent LTV. Nonconforming loans may permit as little as 5 percent down for investors, depending on the financial strength of the borrower. Thus, an investor with excellent credit and provable source of income

Loan-to-Value versus Loan-to-Purchase Price

Loan-to-value is determined by the amount of the loan compared to the appraised value of the property. If the investor is buying a property for less than the appraised value, then the lender's LTV criteria should change, correct? Actually, not—most lenders' LTV criteria are based on the appraised value or purchase price, whichever is less. Based on various studies done by lenders, the statistical chance of a borrower's default decreases if the borrower has more of his or her own money invested.

may be able to borrow as much as 95 percent of the purchase price of an investment property. On the other hand, an investor with mediocre credit and who is self-employed for a short period of time may be required to put 20 percent down. There are a hundred variations, depending on the particular lender's underwriting criteria.

The Down Payment

You need to show at least two months of bank statements to the lender to prove that you have the requisite down payment on hand. If the down payment money suddenly "appeared" in your account, you need to show where it came from. If it was a gift, for example, from a relative, you'll need a letter from that relative stating so. Basically, the lender wants to make sure you didn't borrow the money for the down payment (although some lenders will permit you to borrow the down payment from your home equity line of credit, discussed in Chapter 6). If your credit report shows recently high balances or a lot of recent inquiries from credit card companies, this may be a red flag for the lender. In short, don't expect to borrow the down payment from a credit card or other unsecured line and think the lender won't notice.

Income Potential and Resale Value of the Property

The particular property being financed is relevant to the lender's risk. If the property is a single-family home in a "bread and butter" neighborhood, the lender's risk is reduced. Because middle-class homes in established neighborhoods are easy to sell, a lender feels secure using them as collateral. However, if the property is in a neighborhood where sales are not brisk, the lender's risk is increased. Also, if the property is very old or nonconforming with the neighborhood (e.g., one bedroom or very small), then the lender will be tighter with their underwriting guidelines. On the other hand, the stronger the local economy, the more likely a lender will be to waive the strictest of their loan guidelines.

Financing Junker Properties

One of the major headaches you will run into as an investor is trying to finance fixer-upper properties. Many banks shy away from these loans because a subpar property doesn't meet the strict FNMA lending guidelines. Also, lenders based their LTV and down payment requirements on the purchase price, not the appraisal. Thus, you are penalized as an investor for getting a good deal.

☛ **Example:** A property is worth $100,000 in good shape and needs $15,000 in repairs. The investor negotiates a purchase price of $70,000. The lender offers 80% LTV financing, which should be $80,000, right? Wrong! The lender offers 80% of the purchase price or appraised value, whichever is *less.* So, the lender would expect the borrower to come up with 20% of $70,000, or $14,000, offering $56,000 in financing.

Dealing with junker properties requires a lender that understands what it is you do. A small, locally owned bank that portfolios its loans will be your best bet. The lender may even lend you the fix-up money for the deal. An appraisal will be done of the property, noting its current value and its value after repairs are complete. The lender will lend you the money for the purchase, holding the repair money in escrow. When the repairs are completed, the lender will inspect the property, then authorize the release of the funds in escrow.

Refinancing—Worth It?

A corollary to financing properties is the concept of refinancing. When and how often should you refinance your investment properties? Should you take advantage of falling interest rates?

The rule of thumb is that you should not refinance your loan unless it is a variable rate or your new rate is 2 percent lower than your existing rate (that is, 2 points lower—not 2 percent of your current rate—such as 8 percent down to 6 percent). However, this rule of thumb is just that—a guideline. There are costs involved in getting a loan, and it takes several years of payments at the lower rate to recoup your investment. Also, keep in mind that if your existing loan has been amortized for several years, you are starting to pay less interest and more principal on your current loan; refinancing means starting all over again.

The bottom line is to use common sense and a calculator—figure out whether the interest savings is worth the extra cost (and potentially the risk) of refinancing.

Filling Out a Loan Application

You should be familiar with FNMA Form 1003, a standard loan application form used by most mortgage brokers and direct lenders to gather information about your finances. You should also have one filled out on your computer that you can provide to your lender (you can download a fillable Form 1003 on my Web site at <www.legalwiz.com/1003.htm>. You should always fill out a Form 1003 truthfully and honestly, but, like income tax returns, there are many "gray areas" when it comes to stating your income, debt, and assets. If you have any doubt, have your mortgage broker review it before submitting it to the lender.

Cash Out Refinancing

Many investors refinance every few years as property values increase, using the extra cash to buy more properties, as suggested in Robert Allen's best-selling book, *Nothing Down for the '90s.* While this process does increase your leverage, it also increases your risk. There is nothing inherently wrong with taking out cash in a refinance, so long as the cash is used wisely. Spending the money as profit is not a smart use. Paying off credit cards with that money isn't always a smart use of cash either because you are taking unsecured debt and substituting it with secured debt. While it may seem like the monthly payments are lower, the expense of the refinance hardly makes it worthwhile. And if you end up with a high LTV and/or negative cash flow on the property and housing prices fall, you are in for a world of financial hurt.

Key Points

- Lenders make their profit in a variety of ways—the key is understanding how they do it, and paying the minimum you need to get a good loan at a fair price.
- Choose a mortgage company that has the requisite experience and can handle your business.
- Understand the basic loan criteria before you apply for a loan.
- Refinance only when the numbers make sense.

CHAPTER 5

Creative Financing through Institutional Lenders

The power of thought—the magic of the mind!

—Lord Byron

While having a good mortgage broker or lender on your side is very valuable, you still need to have a few tricks in your back pocket to make things work. One of the main challenges for the investor is to buy properties with little or no cash, yet still have a low enough payment to avoid negative cash flow. This chapter will discuss some of the ways to do so.

Double Closing—Short-Term Financing without Cash

If your intention is to buy a property and turn it around quickly for a cash profit, it is almost a sin to pay loan costs. Known as a *flip,* the investor wants to make \$5,000 to \$10,000 turning a property that he or she buys at a bargain price. This process can be accomplished without traditional bank financing, much less a down payment.

If a particular seller and buyer cannot be present at the same time, a closing can be consummated *in escrow* (an incomplete transaction, waiting for certain conditions to be met, such as the funding of a loan). Thus, the seller can sign a deed and place it into escrow with the closing agent. When the buyer completes his or her loan transaction, the deed is delivered and the funds are disbursed. In many cases, you can buy and sell the property to a third party in a back-to-back *double closing* (also called *double escrow* in some states). You do not need any of your own cash to purchase the property from the owner before reselling it to another investor/buyer in a double closing.

The seven-step double-closing process works as follows:

1. Party A signs a purchase agreement with party B at a below-market price.
2. Party B signs a purchase agreement with party C, offering the property at market price.
3. The only party coming to the table with cash is party C. Assuming party C is borrowing money from a lender to fund the transaction, party C's bank will wire the funds into the bank account of the closing agent.
4. Party A signs a deed to party B. This deed is *not delivered* but deposited in escrow with the closing agent. Party B signs a deed to party C, which is deposited in escrow with the closing agent.
5. Party C signs the bank loan documents, at which point the loan is funded and the transaction is complete.
6. The closing agent delivers funds to party A for the purchase price and the difference to party B.
7. The closing agent records the two deeds one after another at the county land records office.

As you can see, no cash was required by party B to close the transaction. Party B's funds came from the proceeds of the sale from party B to party C. If the second sale does not happen, the first transaction, which is closed in escrow, cannot be completed. At that point, the deal is dead.

If you are doing a double closing, you are acting as both buyer and seller. A double closing is actually two separate transactions. If you do not want party C to meet party A, the double closing can be completed in two phases rather than all at once. Obviously, you cannot give the seller funds until your buyer gives you funds. Thus, one of the two transactions must be closed in escrow until the other is complete. Often, this escrow closing may last an hour. The bottom line is you cannot close with the owner if your third-party buyer does not deliver funds to you.

If you are interested in more information about the flipping process, pick up a copy of my book, *Flipping Properties* (Dearborn Trade, 2001).

Seasoning of Title

In recent years, some lenders have been placing "seasoning" (time of ownership) requirements on loan transactions. Some lenders are afraid to fund the second part of a double closing because of the possibility that the buyer's purchase price is inflated. The lenders are acting mostly out of irrational fear because of a recent barrage of real estate scams reported in the newspapers.

Property flipping scams. There has been a lot of negative press lately about double closings. Scores of people have been indicted under what the press has called "property flipping schemes." Some lenders, real estate agents, and title companies will tell you that double closings are illegal. In fact, they are nothing of the sort.

The illegal property-flipping schemes work as follows. Unscrupulous investors buy cheap, run-down properties in mostly low-income neighborhoods. After they do shoddy renovations to the properties, they sell them to unsophisticated buyers at an inflated price. In most cases, the investor, appraiser, and mortgage broker conspire by submitting fraudulent loan documents and a bogus appraisal. The end result is a buyer who has paid too much for a house and cannot afford the loan. Because many of these loans are FHA-insured, the U.S. Senate has held hearings to investigate this practice.

Despite the negative press, neither flipping nor double closings are illegal. The activities described above simply amount to loan fraud, nothing more. As a result, some lenders have placed seasoning requirements on the seller's ownership. If the seller has not owned the property for at least 12 months, the lender will assume that the deal is fishy and refuse to fund the buyer's loan. There really is no solution to this issue other than to deal with other lenders that don't have the seasoning hangup. Make sure you stay in control of the loan process and steer your buyers to a mortgage company that doesn't have a problem with double closings.

Two possible solutions. If the buyer has found a lender that is really stuck on the seasoning issue, you have two options: (1) assign your contract to the end-buyer or (2) have the original owner buy you out of the deal.

If you assign your contract to your end-buyer, he or she will close directly with the owner. However, the end-buyer may not have enough cash to pay you the difference between your purchase price with the owner and his or her purchase price with you. You need to trust that the parties involved will pay you at closing from the seller's proceeds!

The safer way to solve the problem is to approach the owner and ask him or her to buy you out of the deal. *Buying you out* means that the owner is going to pay you to cancel the sales agreement with you so that he or she can enter into a purchase contract directly with your end-buyer. Ideally, it would be best if the owner paid you in cash before he or she closed with your end-buyer. If the owner wants to wait until the end-buyer closes the sale with him or her to pay you the cash, put the agreement in writing in the form of a promissory note, secured by a mortgage on the property. Thus, at closing, you will be paid off as a lien holder.

The Middleman Technique

Many foolish investors and unscrupulous mortgage brokers have been known to "overappraise" a property, effectively financing a property for 100 percent of its value. The mortgage broker then passes the buyer's down payment back to the buyer under the table so that the deal is done with nothing down. Not only is this practice illegal, it is foolish, unless the property can be rented for more than the loan payment.

Again, there is nothing special about buying a property with no money down unless it is profitable to do so. If you can purchase the property at a substantially below-market price *and* with no money down, you then have a good deal. This is buying 100 percent loan to purchase, not 100 percent loan to value.

The problem with buying a property at a below-market price is that conventional lenders tend to penalize you with their loan regulations. As discussed earlier, FNMA-conforming loan guidelines usually require that an investor put up 20 percent of his or her own cash as a down payment. The 20 percent rule applies even if the purchase price is half of the property's appraised value. A common, but illegal, practice is for the buyer to put up the down payment and for the seller to give it back to the buyer after closing. People may get away with it all the time, but this practice is loan fraud.

The middleman technique is a legal way to get around the 20 percent down rule. The process requires the following three important factors:

1. A middleman buyer
2. A negotiated purchase price that is 10 percent to 20 percent below market value

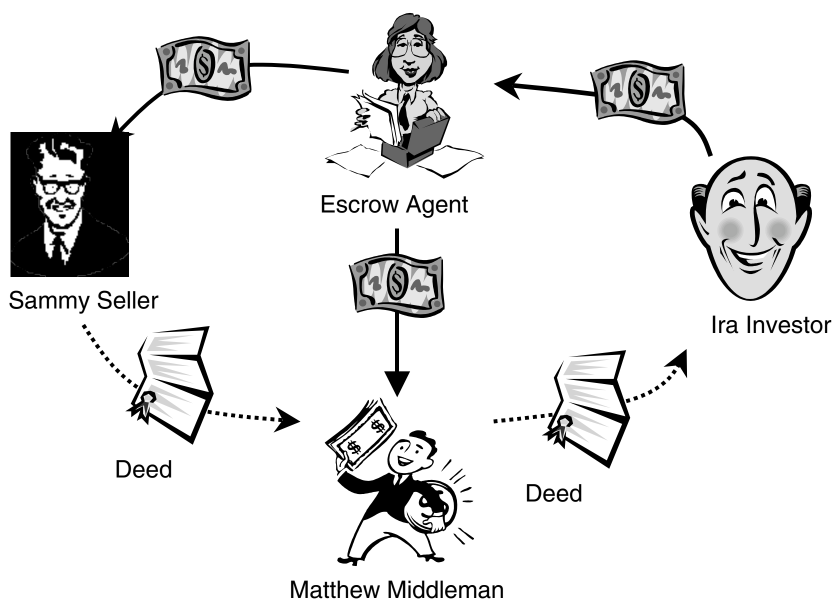
3. A lender that does not require evidence of a cash down payment

Use a middleman partner to buy the house from the owner at a discount and sell it to you for its full appraised value. Do a double closing at which time the middleman buys the property and simultaneously sells to you. The reason for the middleman buyer is to increase the purchase price, because most lenders base their LTV on the lesser of the purchase price or the appraised value. Thus, even if you negotiate a 20 percent discount in the purchase price, the maximum loan you can get is based on the purchase price, not the appraised value.

☛ **Example:** Sammy Seller has a property worth $100,000 and is willing to accept $80,000 for an all-cash sale. Matthew Middleman signs a purchase contract to buy it from Sammy for $80,000. Matthew Middleman then signs a contract to sell the same property to Ira Investor for $100,000. The terms of the contract are $80,000 cash and a note for $20,000, due in ten years. Ira applies for a loan with First National Bank for 80 percent of the purchase price, or $80,000. At a double closing, Sammy signs a deed to Matthew, which is held in escrow. Matthew signs a deed to Ira, which is also held in escrow. First National Bank funds the loan by wiring the money into the account of the escrow agent. The closing agent writes Sammy a check for $80,000. Ira signs a note to Matthew for $20,000. The closing agent records the two deeds back-to-back. Sammy gets his $80,000. Ira gets his property for only a few thousand dollars down (his loan costs). Matthew gets a note from Ira for $20,000. See Figure 5.1.

Epilogue: A month or two after closing, Matthew and Ira become partners when Ira deeds a one-half interest in the property to Matthew in exchange for complete satisfaction of the note.

FIGURE 5.1 Middleman Double-Closing Technique



> *Warning:* Keep in mind that you should disclose to the lender up front that you are not putting up any cash in the deal. Do not, I repeat, do not pay the seller cash at closing and take it back under the table in exchange for a note. This practice is loan fraud, punishable by up to 30 years in federal prison. *See 18 U.S.C. Sec. 1014.*

Case Study #1: Tag Team Investing

I stumbled across a property that was bank-owned and offered by auction to the public. Like many foreclosures, the property was in need of repair (approximately $10,000 worth, in this case). The market value of the property in its existing condition was about $180,000. The bank was willing to accept a bid of $134,000, which was 74 percent of its value.

I brought in a middleman to submit the bid of $134,000 to the bank. The terms of the offer were all cash, which the lender would receive, as explained in a moment.

The middleman then signed a contract to sell the property to me for $180,000. The terms of the sale from the middleman to me were $9,000 cash and a $27,000 promissory note (no payments, interest only, due in five years). The $27,000 note was to be secured by a second mortgage on the property, because I intended to borrow 80 percent of the purchase price ($144,000) and secure the new loan with a new first mortgage on the property.

After the double closing, I owned the property subject to a new first mortgage of $144,000 to an institutional lender and a second mortgage of $27,000 to the middleman investor. The bank that owned the property received their $134,000 in cash, and the middleman investor walked away with about $9,000 in cash. I was out of pocket about $11,000, which was the down payment ($9,000), plus closing costs ($2,000).

I later sold the property for $185,000, at which time the middleman investor agreed to accept a 50 percent discount on the $27,000 note. I used proceeds from the sale to pay the middleman. In the meantime, the payments on the $144,000 first mortgage note were less than I was able to rent the property for.

Case Study #2: Tag Team Investing

A client of mine (we'll call him Chuck) used the middleman method to buy a $1.6 million house with no money down. The property was banked-owned as the result of a foreclosure. Chuck set up a simple living trust for himself with his buddy as trustee. The trust signed a contract (executed by Chuck's buddy, the trustee) to buy the house from the bank for $950,000. Chuck then signed a contract to buy the house from the trust for $1.6 million, the property's appraised value. Chuck gave the trust $400,000 cash and borrowed $1.2 million from an institutional lender. Because Chuck was the beneficiary of the trust, he received the proceeds of the sale (his $400,000 down payment, plus the $250,000 loan proceeds), netting nearly $250,000 cash in his pocket. Needless to say, he has yet to reach into his pocket for a monthly payment on his new loan!

Walk the Fine Line Carefully

In Chuck's example, the lender never asked (nor did Chuck misrepresent) the relationship between the trust and himself. However, if the lender does ask about the relationship between you and the middleman, be truthful. Don't mislead or misrepresent anything to the lender you are borrowing from. It's one thing to be creative with a lender; it's another thing to lie.

Using Two Mortgages

In the Case Studies above, we got around the 20 percent down payment financing requirement by using a seller-carryback loan (discussed in more detail in Chapter 9). This type of loan is known as an 80-15-5 loan; you borrow a first mortgage loan for 80 percent of the purchase price, ask the seller to accept a note for 15 percent of the purchase price, and put down the balance of 5 percent in cash. There are many variations to this formula, such as 80-10-10 (80 percent first mortgage, 10 percent second mortgage, 10 percent down).

In Case Study #2, the seller accepted a note and second mortgage for part of the purchase price. The 10 percent (or more) can also be borrowed from a third party, such as an institutional lender. The ad-

Tax Consequences to the Middleman

You may be wondering, "If the middleman sells the property to you at a profit, isn't this taxable income?" Yes and no. Although it looks like a profit is made, there is no real gain. The middleman, in Chuck's case, was a trust of which Chuck was the taxable owner, so there was no gain. In Case Study #1, the middleman's profit was a note, which is an installment sale. Installment sale income is taxed when the gain is actually received, not when the note is executed. In that particular case, no gain was received until the note was paid in full (in my case, it was only paid 50 percent, which was taxable income to the middleman).

vantage of using two loans as opposed to one 90 percent or 95 percent LTV loan, is that the underwriting requirements are easier on the 80 percent LTV first mortgage loan (and you avoid the PMI requirement, discussed in Chapter 3). Generally speaking, nonconforming lenders aren't as concerned with the source of the down payment or whether the borrower offers cash or a note (or other financing) for the balance of the purchase price. So long as the primary lender is in a first mortgage lien position at 80 percent LTV or less, they are fine with the seller accepting a note or the borrower obtaining some of the difference in the form of a second mortgage loan.

No Documentation and Nonincome Verification Loans

Conforming loans generally require strict proof of income, assets, and other debts. If, for example, you cannot prove income to a lender, whether it is because you are self-employed for a short time or

Get Out the Calculator

Using a first and second mortgage in lieu of one larger loan may not make sense until you do the numbers. Surely, a second mortgage loan as described here will carry a higher interest rate because of the lender's increased risk of being in second position. Make sure the "blended" interest rate between the first and second mortgages does not exceed what you otherwise would be paying with a larger, single first mortgage loan. Also, keep in mind that a larger first mortgage loan may also mean you are paying private mortgage insurance, so that must be factored into the monthly payment.

How to Calculate a Blended Interest Rate

Multiply each interest rate times the amount it relates to the total debt, then add them together. For example, if you have an $80,000 first mortgage loan at 8%, and a $20,000 second mortgage loan at 10%, the blended rate is (8% × .8) + (10% × .2) = 8.4%.

can't otherwise prove income, there are nonincome verification (NIV) loans.

NIV loans (also known as "stated income" loans) require less documentation than traditional loans. Lenders often advertise these programs as "no doc" loans, meaning the borrower does not have to come up with any documentation other than a credit report and a loan application.

Some loans are called "no ratio" loans, in that you don't have to justify your total debt (mortgages plus other continuing obligations, such as car loans and student loans) compared to your income.

Few, if any loans are true "no documentation" loans. Most of these offered programs are bait and switch tactics: The lender says they don't need documentation, but when the loan is being processed, the lender will ask for more and more documentation. Often, the lender will see some red flags that trigger the additional inquiry.

The best defense to these tactics is a good offense; speak to your lender or mortgage broker up front. Identify documentation issues up front, educate the lender about your finances, and be truthful. The more a lender suspects you are hiding something, the more documentation the lender will ask for.

Here is a real-world example: Carteret Mortgage, <www.nva-mortgage.com>, lists the following general guidelines for one of its no-ratio mortgage loans:

- Minimum middle credit score must be 640.
- Five credit accounts are required; three may be from alternative sources—utility, auto insurance, etc.
- Bankruptcy and foreclosures must be discharged for three years with reestablished credit.
- Two years' employment with same employer.
- Two months' PITI reserves are required with an LTV less than 80 percent. Six months' reserves are required otherwise.
- 10 percent minimum down payment is required from your own funds. No gifts.

You should ask for this kind of information up front from your mortgage broker or lender. The more information you know about what a lender needs, the more information you can provide.

Watch What You Say on NIV Loans

Just because you don't have to provide documentation of your income to the lender, it doesn't mean you have a license to lie. Most lenders will make you sign an authorization to release federal income tax returns. They may not check now, but if your loan goes into default, they may obtain copies of your tax returns. If the income you report on your loan application is way out of sync with your tax returns, you may be answering to loan fraud charges.

Develop a Loan Package

You should present a loan package of your own to any new lender. This package should include the following:

- Your completed FNMA Form 1003 loan application (See Appendix C.)
- A recent copy of your credit report, with written explanations of negative information
- A copy of the purchase contract for the subject property
- A copy of the down payment check and documented proof of where it came from
- Copies of recent tax returns, pay stubs, and W-2s (if applicable)
- Recent appraisal of the property if you have one, or a market analysis prepared by a real estate agent
- Copies of existing leases or information of rental value of similar properties

- Copies of recent bank statements, retirement plan accounts, and brokerage accounts
- Any other relevant financial information concerning assets or liabilities.
- References from other bankers, lenders, or prominent members of your community, such as a judge, politician, or bank president

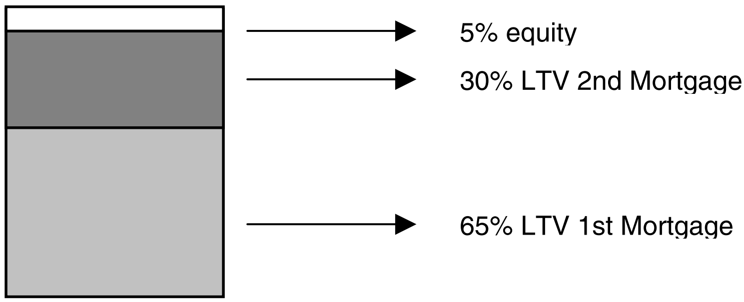
The more information you provide up front, the less surprises the lender runs into, and hence the less likely it will be suspicious and ask for more documentation.

Subordination and Substitution of Collateral

Subordination is asking someone who holds a mortgage (or deed of trust) on your property to agree to make his or her lien *subordinate,* or second in line, to another lien. For example, suppose you own a property worth $100,000 that has a first mortgage to ABC Savings Bank for $65,000. If you want to borrow $30,000 from First National Bank secured by a second mortgage, you would have to pay a much higher interest rate because First National's mortgage would be subordinate, or second, to the lien in favor of ABC Savings Bank. See Figure 5.2. A second lien position is riskier than a first lien position, so the interest rate is generally higher to compensate the lender for its increased risk. If you could convince ABC Savings Bank to move its lien to second position, First National would now be a first mortgage holder and thus give you a better interest rate.

Keep in mind that you can use subordination to draw cash on properties you already own. If you* purchased a property with seller financing, simply ask the former owner to subordinate his or her mortgage to a new first. This may require you to give the seller some incentive, such as additional cash or paydown of the principal. Either way, subordination is an excellent way to finance a purchase or draw money out of existing properties.

FIGURE 5.2 Subordination



Substitution of collateral is a method of moving a lien from one property, or collateral, to another. The substituted property does not necessarily have to be real estate. You can use a car or boat title as the substitute collateral. Better yet, get the mortgage holder to release the mortgage with no substitute collateral! To get someone to take a note without collateral, you need to offer a substantial cash down payment. Think about this: If the note you give the seller is not secured by the property, you can refinance or sell the real estate without paying off the note.

Case Study: Subordination and Substitution

A property owner (we'll call her Mrs. Seller) called me to discuss selling her house. After some negotiations, we agreed to purchase the property for $63,000 as follows:

- $35,000 cash at closing of title
- Promissory note and second mortgage (subordinate to a new first) for $28,000, payable in installments of $350 per month, no interest

She owned the house free and clear, so why would she do such a thing? The answer is, to have her needs met. After some discussion, she told me that she was sick of the upkeep of the property and wanted a brand-new doublewide mobile home. The $35,000 cash was for the new home, and the $350 per month would pay her mobile home lot rent (just so you know that I didn't "steal" the property from some little old lady!).

I went to a hard-money lender (discussed in Chapter 6) and borrowed $37,500 at 12 percent interest (only $35,000 went to the seller; the extra cash was for the points on the loan). I closed escrow, placing a new first mortgage in favor of the hard-money lender, and a second mortgage (subordinate to the first) in favor of the seller for $28,000. My total monthly payments were $725 per month, and I rented the property to a nice family for $800 per month.

A few years later, I wanted to sell the property, so I called Mrs. Seller and asked if she would be willing to take a discount on the amount we still owed her, which was approximately $20,000 (remember the original amount was $28,000). She said that she liked the monthly payments and didn't want me to pay her off! With that, she agreed to accept $10,000, release the mortgage from the property, and allow us to continue making payments on the $10,000 balance of the unsecured promissory note. Not only did we profit from the sale of the property, we also walked away from closing with an extra $10,000 cash in our pockets! The extra cash was due to the fact that we only paid her $10,000 towards the balance of the $20,000 debt still remaining. We continued to make monthly payments on the note, but because the security (mortgage) was released from the property, we received the cash from the proceeds of the sale.

As you can see, subordination and substitution of collateral are two powerful tools to make you more money in real estate.

Zero-Interest Financing: The Exception to the "Cash Flow Is King" Rule

In Mrs. Seller's case, the payments on the high-interest-rate first mortgage plus the owner-carry second mortgage were only slightly less than the market rent for the property. However, because the payments on the owner-carry second were for zero interest, the equity pay-down far exceeded the value of the cash flow. Zero-interest financing is one of the rare instances where monthly cash flow is not the investor's first concern.

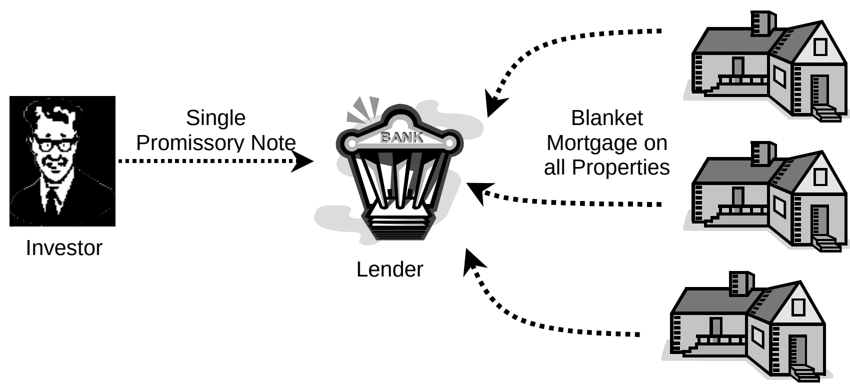
Using Additional Collateral

If the lender you are dealing with feels uncomfortable with the collateral or your LTV requirements, offer additional security for the loan. There are several ways to securitize a loan, other than with a lien on the subject property.

Blanket Mortgage

A blanket mortgage is a lien that covers multiple properties. Developers often use a blanket mortgage that covers several lots. When each lot is developed and sold, the lien is released from that lot. A blanket mortgage (or deed of trust) is just like a regular lien, except that it names several properties as collateral. When recorded in county records, the lien is now placed on each property named in the security instrument. See Figure 5.3.

FIGURE 5.3 Blanket Mortgage



If you have other property with equity, even raw land, you can offer this property as additional security for the loan. Be cautious, however, with offering your personal residence as security; failure to make payments can make you homeless!

Using Bonds as Additional Collateral

A bond, like a note, is a debt instrument. In return for the loan, the investor is paid in full at a future date. Bonds generally pay interest at fixed periods, unless they are zero-coupon bonds. The cash value of a bond at any given time is based on the maturity date and its present value, which in turn is based on whether investors are speculating interest rates will rise or fall in the future. As interest rates fall, bond prices rise, and vice-versa. And, logically, the later the maturity date, the less the present value of the bond.

Municipal and government bonds are virtually the same as cash; they can be traded, sold, and hypothecated (used as collateral). U.S. Treasury bonds are safe, secure investments from a risk standpoint.

From an investment standpoint, they are a fair to good bet, depending on interest rates and market inflation.

Most laypeople think of bonds as being a secure investment. Of course, institutional lenders are generally too savvy to accept the face value of a bond as collateral. However, when dealing with a private motivated seller, an owner-carry offer that is cross-collateralized with U.S. Treasury bonds sounds appealing. When making an offer to a seller with owner financing, offer the face value of the bond as collateral. Although the present value may be less, the very idea of a bond as additional collateral sounds safe. Furthermore, bonds can be used in lieu of a down payment.

☛ **Example:** Sonny Seller owns a house free and clear and is asking $100,000 for his house. Brian Buyer offers Sonny $110,000 as follows: $30,000 in U.S. Treasury bonds and an $80,000 note secured by a mortgage on the property. The $30,000 in bonds, if they matured in 30 years, can be bought for a fraction of their face value, depending on the market interest rates. In the seller's mind, he's receiving more than the asking price, but the buyer is paying much less than the asking price (sometimes sellers are stuck on asking price just because they are ashamed to tell their neighbors they took less!).

For an excellent reference on using bonds as collateral for real estate financing, I recommend *Formulas for Wealth* by Richard Powelson, Ph.D. (Skyward Publishing, 2001). For more information on bonds, try <www.savingsbonds.gov>.

Key Points

- Avoid loan costs on flips—use the double closing.
- Use the middleman technique to overcome lender down payment requirements.
- Don't let lack of income hold you back—use NIV loans.
- Think beyond the property for collateral: substitute, subordinate, and cross-collateralize.

CHAPTER 6

Hard Money and Private Money

A loan shark is simply a thief without a Wall Street office.

—Lyndon H. LaRouche, Jr.

An often overlooked and very valuable source of funding is private money. Small companies and individual investors called "hard-money lenders" are an excellent resource for quick cash. Private lenders are often known as hard-money lenders because they charge very high interest rates. I have personally borrowed at 18 percent with 8 points as an origination fee! These rates may sound outrageous at first blush, but it is the availability of the money not the cost that matters.

Emergency Money

I recently won with the high bid on a condominium auctioned by the Department of Veterans Affairs (VA). I made the bid in the name of a corporation rather than my individual name. I was assured by my mortgage broker that the lender that had my loan application would permit me to finance the purchase in a corporation. At the 11th hour, the lender changed its mind, requiring me to close in my individual name. I asked the VA for permission to amend the purchase contract to name me, rather than my corporation. The VA refused, and I now had less than five days to close or lose the deal. Because my winning purchase bid was an excellent price, I opted for using hard money to purchase the property. I paid 14 percent interest for a few months, then refinanced the property at a good interest rate. All in all, the high cost of the hard-money loan was worth it and saved me in a pinch.

Hard-money lending criteria are based on the collateral (the property) rather than the financial strength of the borrower. For this reason, hard-money lenders are often referred to as "equity" lenders. A hard-money lender looks at a loan, thinking, "Would I want to own this property for the amount of money I lend this person?" Hard-money lenders generally go no higher than a 75 percent loan-to-value. The goods news, however, is that many hard-money lenders will base their loan on appraised value, not purchase price. So, if you negotiate a very good purchase price, you may end up with an 85 percent loan-to-purchase ratio.

Hard-money lenders can be expensive but also easy to deal with if you are in a hurry for the money. In many cases, the availability of the money is more important than the cost of borrowing it.

Where to Find Hard-Money Lenders

Hard-money lenders are fairly easy to find, once you know where to look. The first place is your local newspaper, under "money to loan." The ads will usually look something like this:

Stop Foreclosure! Real Estate Loans.
Fast and Easy. No Credit Required.
48-Hour Funding. Call Fred 555-1134.

Many hard-money lenders advertise on the Internet. Try a Yahoo! search of the Internet for hard-money lender Web sites. Not all hard-money lenders call themselves that; some use the title "equity based lender." It is best to find one that is located within your state. A referral from another local real estate investor is helpful, too. For a referral to a local real estate investors club in your city, try the National Real Estate Investors Association at <www.nationalreia.com>.

Borrowing from Friends and Relatives

Friends and relatives seem like obvious choices for borrowing money, but they may be as skeptical as an institutional lender. They may try to boss you around and nag you about when you expect to repay the money you borrowed. They may also want to be part of the daily decision-making process, which would interfere with your business. And, of course, they may be emotional about their money, whereas institutional lenders don't take money matters personally.

Borrower Beware! Soliciting money from private investors can be a dangerous practice. Federal securities laws may apply to public solicitations of money as a "public offering." In addition, state securities regulations (known as "Blue Sky Laws") may also apply. Simply running a blind ad in the paper stating, "Private Money Wanted for Real Estate Purchase—12% Return" may result in a call from your state Attorney General's Office. If you are approaching a friend, relative, or individual investor to borrow money secured by a specific property, then you are probably OK; borrowing money for a "pool" of funds becomes trickier. Also, when you deal with strangers, multiple parties, or the public at large, you should seek the advice of a local attorney knowledgeable about state and federal securities regulations.

Using Lines of Credit

A home equity line of credit (HELOC) can be an excellent financing tool, if it is used properly. A HELOC is basically like a credit card secured by a mortgage or deed of trust on your property. In most cases, it will be a second lien. You only pay interest on the amounts you borrow on the HELOC. You can access the HELOC by writing checks provided by the lender.

HELOCs are being advertised on television as a way to consolidate debt, but they can be used much more effectively by investors. When you need cash in a hurry for a short period of time, a HELOC can be very useful. For example, if a seller tells you to give him "$75,000 cash on Friday and I'll sell you my house for a song," you need to act in a hurry. Another example of cash in a hurry is a foreclosure auction, which, in many states, requires payment at the end of the day of the auction. When you need cash in a hurry, there's no time to go to the bank.

While the HELOC may be a high-interest-rate loan, it is a temporary financing source that can be repaid when you refinance the property. *Do not use your HELOC as a down payment or any other long-term financing source—it will genera lly get you into financial trouble.* Furthermore, an institutional lender may not lend you the balance if you borrowed the funds for the down payment.

Warning: Failure to pay your HELOC means you lose your home! Use your HELOC wisely and only if it means losing a steal of a deal if you don't!

Credit Cards

You may already have more available credit than you realize. Credit cards and other existing revolving debt accounts can be quite useful in real estate investing. Most major credit cards allow you to take cash advances or write checks to borrow on the account. The transaction fees and interest rates are fairly high, but you can access this money on 24 hours' notice. Also, because credit card loans are

Deducting HELOC Interest

There are limits on the deductions you can take on your personal tax return for interest paid on your HELOC. Generally speaking, you can only deduct that portion of interest on debt that does not exceed the value of your home and is less than $100,000. But, if you do your real estate investments as a corporate entity, you can always loan the money to that entity and have the entity take the deduction as a business interest expense. This transaction must, of course, be reported on your personal return and must be an "arms-length" transaction (i.e., documented in writing and within the realm of a normal business transaction). Consult with your tax advisor before proceeding with this strategy.

unsecured, there are no other loan costs normally associated with a real estate transaction, such as title insurance, appraisals, pest inspections, surveys, etc.

Often, you will be better off paying 18 percent interest or more on a credit line for three to six months than paying 9 percent interest on institutional loans that have up-front costs that would take you years to recoup. Again, use credit cards carefully and only as a temporary solution if the deal calls for it.

Key Points

- Hard money is an excellent short-term financing tool.
- HELOCs and credit cards are excellent sources for fast cash.

CHAPTER 7

Partnerships and Equity Sharing

The guy with the experience approaches the guy with the money. When the deal is complete, the guy with the experience has the money, and the guy who had the money has experience.

–Anonymous

If you are low on cash or have cash and are low on time, a partnership or equity-sharing arrangement may be for you. Using partners to finance real estate transactions is the classic form of using other people's money (OPM). Experienced investors are always willing to put up money to be a partner in a profitable real estate transaction. As with many businesses, talent is more important than cash. If you can find a good real estate deal, the money will often find its way to you!

Partnership arrangements work in a variety of circumstances. The most common scenario involves one party living in the property while the other does not. Another scenario may involve all of the parties living in the property. These arrangements are common among family members. Parents often lend their children money for a down payment on a house, with a promise of repayment at a later date. If the repayment of the debt is with interest and/or relates to the future appreciation of the property, we have a basic equity-sharing arrangement.

Another common financing arrangement between multiple parties is a partnership wherein none of the parties live in the property. This chapter will discuss the basic partnership investment. Larger investments through limited partnerships and other corporate entities in a "pool" of money are known as "syndications." These investments are generally classified as securities, so compliance with state and federal regulations is complex. Thus, syndications are generally not recommended for financing smaller projects because the legal fees for compliance with securities laws will far exceed the benefit of raising capital through multiple investors.

Basic Equity-Sharing Arrangement

The common equity-sharing arrangement involves one party living in the property and the other putting up cash and/or financing. Both the occupant and the nonoccupant enjoy tax benefits and share the profit, as described later in this chapter. First-time homebuyers make the best resident partners while family members, sellers, and real estate investors fill the nonresident partner role.

Scenario #1: Buyer with Credit and No Cash

A lot of potential homebuyers have the income to qualify for a mortgage loan, but only with a substantial down payment. With a small down payment, the monthly loan payments may be too high. A potential homebuyer could borrow the money for the down payment, but nobody but a fool (or a parent) would lend $25,000 or more unsecured. Furthermore, loan regulations generally do not permit the use of borrowed money as a down payment.

An equity-sharing partner could put up the money in exchange for an interest in the property. The resident partner would obtain the loan, live in the property, make the monthly loan payments, and maintain the property. The nonresident partner who puts up the down-payment money is free from management headaches and negative cash flow. After a number of years (typically five to seven), the property is sold, the mortgage loan balance is paid in full, and the profits are split between the parties. Obviously, the strategy works best in a rising real estate market.

Scenario #2: Buyer with Cash and No Credit

The second equity-sharing scenario would be a buyer with cash but an inability to qualify for institutional financing. The resident partner would put up the down payment, the nonresident partner would obtain the loan. After a number of years, the property is sold, the mortgage loan balance is paid in full, and the profits are split between the parties.

Your Credit Is Worth More Than Cash

Just because you put up credit and no cash does not mean you aren't at risk. Cash is easy to come by, but good credit takes years to build, and only months to ruin. As I write this book, an investor friend of mine (we'll call him Brian) recalls his first deal. Brian was a neophyte investor who was approached by an experienced investor with the following proposal: "You put up your credit to get the loan; I'll put up the cash for the down payment." Brian bought the property with the investor in this manner, but Brian did not manage the property. Brian received a call from the lender a year later and was informed that the mortgage loan had not been paid in several months. Brian was unable to locate his partner who had apparently collected the rents and skipped town.

The moral of this story: Use your credit wisely—cash can be recouped in a few months, but credit blemishes can take years to fix.

Tax Code Compliance

Equity sharing arrangements are governed by Section 280A of the Internal Revenue Code (IRC). Labeled a Shared Equity Financing Agreement (SEFA), IRC Section 280A permits the nonresident partner investment property tax benefits (namely depreciation). In addition, the resident partner can take advantage of the benefits of owning a principal residence (namely, the mortgage interest deduction).

The nonresident partner is essentially treated for tax purposes as a landlord, taking depreciation for his or her ownership interest to the extent he or she receives rent. So, for example, if fair market rent for the property is $1,000 per month and the resident/nonresident equity split is 60/40, then the resident must pay $400 in rent to the nonresident partner if the nonresident wants to take the depreciation deduction. In turn, the nonresident partner returns the rent to property expenses for which the resident partner is responsible (in this way, the cash contribution by the resident partner is not increased—it is just shifted to conform with the tax code). If the resident does not pay rent, but rather makes all of the mortgage interest payments directly to the lender, then the investor receives no tax benefits, leaving them all to the resident. The agreement can be made in a number of ways, depending on the needs of the parties and their needs for the tax deductions.

The parties must have a co-ownership agreement that complies with IRC Section 280A in order to reap the benefits of this mixed use tax plan. If the relationship is deemed a "partnership" by the IRS, then the rules of IRC Section 280A are not applicable. A highly recommended book that covers the tax implication in detail is *The New Home Buying Strategy* by Marilyn Sullivan, Esq., <www.msullivan.com>.