DAVID REED

Author of *Mortgages 101* and *Mortgage Confidential*

THE REAL ESTATE INVESTOR'S GUIDE TO FINANCING

Insider Advice for Making the Most Money on Every Deal

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I dedicate this book to Jim and Glenda Nees for all they've done for both me and my family. Thank you.

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CHAPTER 1

Basic Finance for the Investor

While there are certainly plenty of real estate books on the market that specialize in real estate investment, those same books fall short when it comes to one of the most important aspects of real estate investing: financing.

Buying real estate as an investment can bring great rewards. Holding real estate and watching its value rise over the long term is a nice way to retirement for many people.

One of the advantages of real estate can also be a disadvantage, however. It's not a liquid asset. You can't get your money out of it as easily as you can get money out of an ATM. If it's a stinker, you have to sell it, and that takes time and it takes money.

You can't just change your mind because of a heavy dose of buyer's remorse, take your receipt for your investment condo back to the store, and get your money back after saying something like, "Well, it was the wrong size, and my aunt gave me one for Christmas."

Real estate investment needs commitment. You need to decide that it's right for you before you get involved.

There are two different types of investors: those who buy and hold, and those who buy and sell quickly, a process that is often called *flipping*. Flippers attempt to find bargains, fix them up, then sell them for a profit. And these two types of investors are not exclusive; you can both be a flipper and hold for the long term.

Flipping brings a whole new element to real estate investing compared to simply holding onto property for a long period of time, then either selling it when you think you've made enough money or keeping it and passing it down to your grateful heirs.

Flipping requires more than just buying; it requires you to know how to make repairs on a home and evaluate how much of a return in the form of increased value those repairs would generate. Or maybe the issue isn't just increased value but simply making the place livable.

Flipping requires different financing strategies from those used for long-term investments. Any real estate investment book you read concentrates more on either finding, fixing, and flipping real estate or finding and keeping real estate while paying little attention to the financial aspect—perhaps one of the most critical pieces of the real estate investment puzzle.

Getting the wrong financial package can wipe out your profits, hold you back from selling because of lack of equity, or perhaps require you to sell for more than the market will bear because of the bad loan you got when you bought the property in the first place.

If you're a flipper, financing is critical. If you're long term, financing is also critical, but at least in long-term deals you can always refinance the property down the road if you made a bad loan choice in the beginning. We'll discuss refinancing investment properties in detail in Chapter 4.

But then again, because you're reading this book, you won't be making those mistakes, now will you?

One advantage that a long-term investor has is the ability to buy in other markets.

Let's say, for instance, that your local real estate market is humming right along. You know that you can find a property, fix it up, and sell it for a profit. Or maybe your market is really moving and you can find a piece of property that takes absolutely no work (or very little), and because of the real estate demand in your area, you know you can make another 10 percent on your investment.

You know you can do this because you know your market. You know the neighborhoods. You know the contractors who work on your properties, or if you do most of the rehab yourself, you can drive to the job site every day.

That's not true if you're buying in Texas and you live in California. Yes, you can fly in and look at properties, but if you want to fix and flip, you've got a brand-new problem. How do you find someone you trust to be the contractor while you're a couple of time zones away? How do you monitor the contractor's progress?

How do you pay the workers, and how do you make sure they're not sitting around drinking beer all day long while you're frantically trying to get your contractor to return your voicemails?

The truth is, you can't. If you're a flipper, then a long-distance rehab project may not be for you. In fact, if you were planning on making $20,000 on a nice little flip, then all the labor, plane fare, and headaches won't be worth it at the end.

Yes, you can be a long-distance flipper if the properties you're buying don't need any work and you think you can sell them quickly and for a profit. Yet, you're not local. You're not the only real estate investor, and there will be local professional investors who can sniff out a flip a lot more quickly than you can simply by being where the property is. By the time you've found a potential investment, gotten on the plane, and rented a car to look at your potential investment, if it was such a good deal, it's probably been snatched up while you were checking your bags.

I will note that sometimes faraway investors can have the upper hand when they're in a part of the country that is doing better economically than the locale they want to invest in.

For instance, a town may have experienced some huge layoffs as a result of downsizing, creating a significant economic hit. If you are living in an area that is not depressed, you may have more disposable income and be able to buy a house for less than market value.

But even then, as a flipper, if you invest in a depressed area, who are you going to sell to—another flipper? If the local economy you're buying into is in the middle of some major economic upheaval, then home buyers aren't exactly going to be lining up along the street waiting to bite on that "bargain" house you found. Many of the people in the town where you found your bargain have, unfortunately, been laid off.

Being a long-distance flipper, then, is a challenge. You don't know the area as well as the locals do, you can't monitor your project efficiently, and it's hard to find buyers in a depressed market.

On the other hand, such opportunities bode well for long-term investors. If you see that a certain area outside where you live is going through some difficult times, you can find a bargain house and hold onto it, waiting to sell until the economy recovers.

I own a home in Austin, Texas, that I bought in the late 1990s. The seller was an investor from California who had bought the house some 10 years earlier—right in the middle of the S&L debacle. Combine that crisis with an oil and gas industry that was suffering through perhaps one of its most trying times, and you can see why real estate in Texas was depressed.

The investor bought in 1988 during an economic downturn in Texas and sold 10 years later, doubling his money, after the economy recovered. He was long term.

Not just that, but the property I bought was listed as a "fixer-upper" that needed some "tender loving care," meaning that it had its challenges. In fact, the California owner had never lived in the property but had rented it to various people for the entire decade.

When I bought the house, it needed some work. The carpet was old, the tile in the kitchen area was coming up, and the entire house needed some significant updating—Significant with a capital S.

My wife and I had been looking in that particular part of Austin for nearly a year, trying to find the perfect deal. We had seen so many similar houses that we knew immediately that the property was a steal. The property had been listed, and within 24 hours of its original listing, it had had three offers—all from locals.

We not only offered the asking price but also bumped it up by a few thousand dollars (because we knew we had found a bargain) and won the bid. We bought the home, completely remodeled it, and turned it into a very nice piece of property. We still own the home today, and the property has appreciated nearly fourfold since we bought it. And I doubt that we will ever sell it. Okay, we will, but not for a long, long time. I know the area, and it's a keeper.

Sometimes people get into real estate investments by accident. For instance, you find a house you really, really want to move into, but your current property isn't selling for what you'd like to sell it for, so you keep it and rent it out.

Or perhaps you inherited a property from a relative and decide to keep it long term and not sell right away.

Occasionally life simply causes you to get into real estate when you had no initial motivation to do so. You'd never thought of it, and now you're in it. And you find out you like it!

The Pros and Cons of Being a Landlord

First and foremost, the landlord owns the property and collects (hopefully) the rent each month. The landlord is also at the bidding of her tenants when it comes to repairs and maintenance of the property.

This doesn't mean day-to-day maintenance. A landlord may not be responsible for a clogged sink, but he might be responsible if the clogged sink is due to tree roots from outside the house invading the outdoor plumbing.

Typically, if something goes wrong, you as the landlord have got to fix it. If it's an emergency situation or something that makes the property uninhabitable or dangerous, not only may the terms of the rental agreement require you to fix it, but local or state laws may also require that you fix it.

Think fallen tree limbs knocking down power lines or a flood from a broken pipe. Or suppose there's no heat in the winter or cool air in the summer because of a poor heating or cooling system.

This means that you've got to have some money handy, or at a minimum a few credit cards or trade lines opened up at Lowe's or Home Depot. When your tenants squawk, you'll need to have whatever they're squawking about fixed, and pronto.

Being a landlord also means collecting rents on time; after all, if one of the reasons you want to buy investment property is to have the tenants pay your mortgage for you, then it stands to reason that you'll want to be paid on a regular basis.

That's also one of the advantages of holding: having someone else pay your mortgage for you while your asset appreciates in value. Let's look at an example of how that works.

You want to buy a duplex for $200,000, and you put 20 percent down. You finance the property at 6.50 percent for 30 years, so the monthly payments you make to the mortgage company come in at around $1,250 per month, including taxes and insurance.

Rents in that neighborhood go for about $900 per month per unit, so your duplex brings in about $550 per month over and above your payments. That's not counting regular maintenance, but you're still ahead.

Now let's also assume that property in that area is appreciating at a rate of about 5 percent per year.

After five years, you've made just over $33,000 in additional income. Your tenants have paid for your investment by more than making your payments each month. Your property has also appreciated to $255,250.

The total value of your holdings = $40,000 down payment + $55,250 appreciation + $33,000 income. That's a $128,250 equity position, or a gain of $88,250. Plus, if you invested that $33,000 in income at a 5 percent annual yield, you probably made even more.

These are the kinds of numbers you need to keep in your head when you get a call at 2:00 a.m. from your tenant complaining that there is no hot water. Besides wondering what she's doing up at 2:00 in the morning needing hot water, you have to answer her call.

What makes for a good landlord? Easy: A good tenant living in a good property.

If your tenant pays his rent on time, then you'll have enough money to pay your bills on time. If the property you own and rent out is in good shape and is not inclined to disrepair, then you'll spend less time fixing hot water heaters and maybe more time making how-to-get-rich-quick infomercials while sipping margaritas.

Take the Headache Out of Being a Landlord

Another way to be a good landlord is to have someone else be a landlord for you by using a property management company. Most property management companies have some sort of affiliation with a real estate company, if they are not owned outright by such a company.

These firms do all the dirty work for you. They keep up the property for you, they collect the rent, they send out repair companies to fix that bad hot water heater, and they screen tenants. They charge a fee for all this, of course. But still, property management companies do this for a living, and they both have experience in daily property management and have built relationships with other affiliated services, such as carpenters or repairmen, who work for them and offer discounts for their services as well.

All of this is your call, of course, but as you acquire more properties, you're going to need some help, so either you can hire some staff to do the work for you and work at this full time, or you can have another company do the daily tasks for you.

I know a lady who owns multiple properties and has one neat handyman whom she employs full time and who does nothing except be on call when her tenants have a problem. She owns houses and apartments and duplexes, but she has a guy who works directly for her who goes out and fixes things when they're broken. Needless to say, he's busy. But he works directly for her. She doesn't have to share him with any other property owners, as she would if she hired a management company.

There's also an in-between. You can have a management company just collect the rent while you take care of repairs, or you can have the management company find renters for you while you take care of anything or everything else. It all depends on your agreement and your schedule. It's up to you.

Or you can hire somebody you know and trust with all your heart—your spouse, or your son or daughter, or really anyone you know well. But being a landlord means managing and maintaining your asset. Your renters won't be there forever, so it's up to you to keep the property in good shape for the next tenants and to establish a reputation for being a nice landlord who fixes stuff when it breaks.

Setting Up the Utilities

There's something else to consider when renting property, and that's the utilities. Who takes care of the electric bill, the water, the phone, the cable? That can depend on the type of property you own, such as a single-family unit or a multifamily property like an apartment building.

You can set up any arrangement that you want, but to avoid the hassles of paying utility bills and monitoring their usage, you can simply have the tenants pay their own way when it comes to things like water and sewer or oil and electricity.

If your property is an apartment building and the units don't have separate metering, then you may not have that luxury, so instead you can divide the total unit cost of utilities equally among the number of apartment units and consider that per-unit cost when determining rental rates.

Both utilities and maintenance are costs of owning and need to be considered when setting rental rates. After all, you're in this to make money, not lose it, right?

Setting Rental Rates

The easy way to set rental rates is to figure out how much the property costs you each month in terms of mortgage payment, taxes, and insurance plus maintenance and any utility costs, then charge more than that each month. Before you buy, you should find out what similar rentals in the area are going for. Without knowing this, you won't know whether you will be able to rent the apartment at a rate that will make you money. You can find this out yourself by monitoring the rental rates listed in the paper and online, or you can get a list of comparable apartments from a local Realtor.

Let's look at our duplex again and now add repairs and utilities.

Monthly payment	$ 1,250
Repairs (per month)	$ 100
Water/sewer	$ 75
Total	**$ 1,425**

With this example, anything above $1,425 is what you would make as a profit. This doesn't count intangible expenses such as your worrying about that hot water heater breaking this year or the time and effort you spend managing the property or even the cost of hiring a property management firm.

But with this method, you add your monthly expenses and simply charge more. If you want to make $500 per month on top of the $1,425, your monthly rent would be $1,925. Or divided by two so you can split that duplex profit between the two units, your monthly rent for each side of the duplex would be $962.50.

That's how much you would charge each tenant if you wanted to make $500. Do you want to make more than that? Then charge more. Do you want to make $1,000 more each month? Then sock it to your tenants.

Of course, sometimes you can't do that. What you want to charge in rent and what you can realistically get are two entirely different things. You can really charge only the maximum that the market will bear.

Let's look again at the duplex. In most places where you find one duplex, you'll find another. And perhaps another. That's because the area has been designated, or zoned, by the city or locale as being able to have duplexes, triplexes, and fourplexes. You usually won't find a bunch of single-family residences with one duplex sandwiched among them.

That means that before you buy that duplex, you can see what other duplexes are renting for. If other duplexes are renting their units out for $1,000 per month, then you can expect to get $1,000 per month out of your property as well.

That's all things being equal, of course, such as square footage, number of bedrooms, and the condition of the property. If you want to charge $1,500, you certainly can, but if other units in the area are charging only $900, you won't get any takers. Maybe you can spice up your offer with some free cable TV, or a hot tub, or something else, but there's a difference between what you want to charge and what the market will allow you to charge.

When Should You Buy?

There are "hot" real estate markets and there are "cold" real estate markets and there are "steady" real estate markets.

There can also be hot markets and cold markets in the same city or town, and this can depend upon a variety of factors. In fact, one hot market could be the next cold market, and vice versa.

For example, I know of a public school district that won a couple of "teacher of the year" awards. Suddenly people realized that instead of paying for private schools, they could get a solid education for their kids in a public school. This neighborhood had previously languished for years with regard to real estate values, but it suddenly became very popular.

Now, that school district suddenly created a hot real estate market where there had been none before. This part of town was once shunned, but now, because of the "free" public education, people were moving into the district, paying more for homes than the same homes had sold for just a few months earlier, and driving up prices.

The area was hot. Property values increased. Market rents went through the roof. And the people who had originally bought those homes in that once-downtrodden neighborhood, who had newfound cash that they hadn't had before, sold and moved into bigger houses in other parts of town. They had lived in that neighborhood for years, their kids had grown up and moved on, and now they had newfound wealth through nothing more than market appreciation.

The buyers won and the sellers won.

In both an up market and a down market, different buying strategies emerge and also make the financing aspect even more important.

The Strength of the Market Will Determine What Financing You Should Get

When you're buying in a strong market, you're probably looking at other economic factors for that area that indicate strong economic growth for a long period of time. For example, suppose employers are moving into an area and building new plants. This indicates that people will be moving into the area to be near their work.

When there are indications of a strong market, you should seriously consider holding properties for the long term and therefore look for long-term financing that makes sense. We'll examine in detail which financing types to choose for different holding periods in Chapter 4.

Buying in a growing market may also mean that you intend to buy low and sell high on a relatively short-term basis, such as two or three years. You're betting that your property will appreciate over that period, and you want to unload your appreciating asset a few short years down the road.

Buying in a booming market, where home prices are appreciating at a rapid clip, say 10 to 20 percent or more per year, might even mean selling the property a few months after you bought it. If you anticipate turning a property that quickly, your financing package for that property is key to your profit.

Even in new construction, when home sales are white hot, you can buy a home or a condo that's currently under construction and has not yet been completed, and then turn around and sell that condo to someone else for a still higher price.

This phenomenon doesn't happen very often, but it happens in extremely hot markets. Solid growth and speculative buying can ignite a sales frenzy where new construction can't keep up with the demand. Professional real estate investors can spot this trend and buy early, selling the real estate to someone else for a profit without ever having seen the house or condo completed!

On the flip side, should you buy in a down market? Or should you buy in a market that hasn't yet hit bottom but may be on its way?

Certainly not if you're a flipper, right? Unless you can find some wildly distressed property and a true diamond in the rough, you're taking a big gamble if you're flipping in a down market. If nobody's buying, then who are you going to sell to?

If you're a long-term investor, then buying in a down market makes sense. Prices are lower, and real estate always comes back unless you're talking about Chernobyl or somewhere with similar long-term issues.

Just as there are dips, there are also rebounds. Financing for the long term is essential in a down market; you shouldn't consider short-term notes for this kind of market. This is why you sometimes hear the phrase "real estate is local," meaning that one area can be hard hit with tough economic news while another part of the country is literally booming.

If the national economy is in the doldrums with only pockets of stout economic activity, then there's another byproduct of that gloom: lower interest rates. We'll closely examine how interest rates move in Chapter 5, but overall, mortgage rates will be lower in times of slower economic activity than in times of strong economic activity.

In this scenario, you're really getting the best of both worlds by buying a property at depressed prices in an economy that offers lower rates.

In the long run, however, most housing markets are neither boom nor bust, but simply "steady as she goes." So do you wait until there's a slowing economy to find deals? Of course not; real estate investing is not all about buying in a hot or cold cycle, but about understanding the type of investor you'd like to be, then methodically going about executing your plan.

Then, of course, there's a third choice: Do nothing at all. If you can't find a property to buy and you can't see how you're going to make any money at it, then don't feel compelled to buy something unless the math works out.

I recall a reporter who wanted to do a story on investment properties. She called me up one weekend afternoon and wanted some information about how to finance investment properties.

In particular, she wanted to know what to do if the investment properties she saw were too expensive to buy and she couldn't get them to cash flow each month. How was she going to get around that particular little problem?

As a matter of fact, she confided, that person was her. She was looking into buying real estate as a long-term investment to help with her daughter's college and her own retirement, but she couldn't find anything to buy.

The rents being charged in the area she wanted to invest in weren't high enough to offset the mortgage payments. She called me to see if I had some magical financing trick that could keep her monthly payments low enough so that she could buy the property and make money each month.

The fact of the matter was, she couldn't. She didn't have much, if any, money to put down, but she still thought it was a good idea to invest in real estate. Her direct question to me was: "What should I do?"

I said, "Let me make sure I understand your situation. You want to invest in real estate for the long haul to help pay for college and retirement later on in life as your kids get older and you retire. You also don't want to put any money down on any of these properties. The rents in the area you want to invest in aren't high enough to offset the monthly payments, and you want to know how to get around that. Is that about right?"

"Yes, exactly." She said.

"Well, if you can't afford it and you can't cover the monthly expenses and you don't have any money for reserves, then the answer is to do nothing."

She was somewhat surprised at that and was taken aback a little. "Huh," she said, "I guess I didn't think about that."

But you should. If you can't make the deal work, no amount of creative financing can help. Maybe you should just wait. Or perhaps you shouldn't invest all your money in one big deal but should get your toes wet first.

For instance, suppose you have $100,000 you'd like to invest. Do you want to leverage all your money into one big property or split that money up among several different properties? Or maybe just buy one small property at first? Buy the small property at first. Get your toes wet before jumping in.

Yes, you could make a lot more money on one big transaction, but won't get much sleep at night as you hope that your acquisition price, rehab costs, and selling price all work out as planned. If they do, congratulations. If not, you made a big mistake. How do you know what types of properties to buy? We'll discuss various property types in detail in Chapter 2, but really you should think less about the type of property in which to invest and more about profit.

One of the easiest ways to determine if a house might be a good investment is to compare a property that's on the market with recent sales in the area by calculating the price per square foot.

Price per Square Foot

You'll need access to your local Multiple Listing Service (MLS) for this, either by having your real estate license or having a Realtor perform a search for you. Such a search is commonly called a comparative market analysis, or CMA. A CMA is a detailed evaluation of a property's potential selling price. Among the data that a CMA will provide is a cost per square foot number.

If a property sold for $200,000 and the home is 2,000 square feet, then the cost per square foot is $100. If another house in the same neighborhood sold for $250,000 and is 2,500 square feet, the property again costs $100 per square foot.

Now suppose the property you're considering buying is listed for sale at $225,000 and is 2,500 square feet, or $90 per square foot.

Unfortunately, in reality, comparing price per square foot won't be this easy, as sales prices, square footage, and the condition of the various properties are all likely to be different.

And don't just compare two houses; compare as many as you can find that were sold within the previous 12-month period; anything that was sold longer ago than that wouldn't be considered a "recent" sale, and there could have been external market factors then that are nonexistent now. At a minimum, try to get five recent sales in the neighborhood where you want to buy, then compare cost per square foot. You do this by averaging the costs per square foot of all the properties in your CMA, then compare that number to the figure for the property you're considering buying.

House 1	$106.00
House 2	$109.00
House 3	$ 101.00
House 4	$ 99.00
House 5	$ 97.00
Total	**472 ÷ 5 = $102.40 per square foot**

Now let's say you found a house that is selling for $189,200, or $86.00 per square foot, and the house is similar in size to the ones listed in your CMA, or 2,200 square feet. Based on your average of $102.40 per square foot, the home should sell for $225,280. The difference is a potential $36,080 gross profit.

Verify Your Numbers

If, however, a home is "supposed" to sell for $225,280 based upon price per square foot averages, then your next question is: Why is it listed at only $189,200? There are two likely possibilities:

Distressed sale

Condition of the property

Distressed Sale

A distressed sale occurs when the owners either are forced to sell or want to sell quickly for other reasons. Perhaps the home is going into foreclosure and the sellers need to sell fast, so they drop the price below market. I've seen properties sold below market because the couple who originally bought the home are now getting divorced and want to sell their home, cash out, and move on.

Condition of the Property

This means that the property is in less than ideal selling condition and needs repairs or significant updating to compete with other properties in the neighborhood—so-called fixer-uppers.

In either instance, you need to find out why the property is selling below market, and you can do this by talking to the sellers or the listing agent selling the home. If there is a foreclosure or divorce looming, then that will explain the reduced price. You can quickly pop in, buy the house, and sell it at a profit.

If there are repair issues, you can inspect the home with a professional inspector and review the Property Disclosure Form, which is a document that lists all the things that might be wrong with the property, according to the seller. This document is not an option, it's a requirement, and it helps you determine how much it would cost to bring the property up to scale with other properties in the neighborhood.

After the inspection and the review of the Seller's Disclosure, you need to consider how much it's going to take to repair or renovate the home to make it marketable at closer to the $102.40 per square foot average.

Calculating Returns

If the property does need some work, your next step is to find out how much it's going to cost to repair; if you're not a general contractor, then you need to find one and become best friends. A contractor is a critical part of your team, as we explore in more detail in Chapter 3.

After you present your inspection and disclosure report to the contractor, it's determined that you will need to replace the carpet and update one of the bathrooms, plus you want to add a nice new deck for the backyard.

Replace 1,500 square feet of carpet	$ 6,200
Upgrade guest bathroom	$ 9,400
New deck	$ 7,100
Total	**$22,700**

By adding these costs to the purchase price of $189,200, you get $211,900. That's the amount you'll need to get to break even. Almost.

When you buy and sell real estate, you'll encounter a whole host of closing fees to people from title insurance companies to appraisers to lenders—well, to a lot of people. We'll discuss closing costs in detail in Chapter 6, but they're something that needs to be deducted from your gross profits as well.

Total costs from rehab	$22,700
Closing costs to buy and sell	$ 10,500
Total costs	**$ 33,200**

There's one more thing, interest costs. Depending upon which type of financing you choose, your interest payments could be anywhere from $940 to $1,377 per month. Assuming that it takes you three months to acquire, rehab, and sell the property, then interest costs could be as low as $2,820 or as high as $4,130.

Let's say you chose the wrong type of financing (conventional 30-year fixed), which increased your costs by $1,377. Add the $4,130 to $33,200 and you have a final cost of $37,330.

You have determined that with the new carpet, deck, and bathroom remodeling, you can charge on the high end per square foot for your investment, or $107 per square foot; $107 times 2,200 square feet is $235,400.

Sales price	$	235,400
Less:		
Acquisition price	$	189,200
Costs	$	37,300
Profit	**$**	**8,900**

Or $10,210 if you selected the correct financing option. Is $10,210 over 90 days enough for you? No? Then flip more than one house during that period.

You're not buying to flip? Then you should have chosen the higher interest payment.

It's time to figure out the best ways to finance your real estate so that you can make more money, sleep at night, and always know that you're on the right financial track. Good financing makes for good investments. Bad financing leads to nightmares . . . or worse.

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CHAPTER 2

Types of Investment Property

So you want to invest in real estate. But what kind of real estate? A cute little bungalow down the street? A duplex? A fourplex? A condo? An apartment building? Raw land? Spec construction?

Different types of property require different financing options, and certainly there is no "one size fits all" approach to real estate finance. Buying an empty lot will require a different strategy from buying a condo downtown. Most real estate investment books that you read give only a passing reference to financing, when in fact how you finance the property is just as important as what you pay for it.

If your mortgage payments outstrip the income from the property, you're going negative each month and perhaps relying only on some real estate losses to help you out come income tax time.

But different types of real estate offer different financing opportunities.

Raw Land

There are two types of real estate: improved and unimproved. Raw land is, of course, unimproved. This means that no structure has been built on the land to "improve" it.

(Some could argue with this term, saying that some land needs to stay pristine, and I completely agree with them. I know of some absolutely beautiful pieces of property that have no "improvements" like a big house and a swimming pool but do have acres of grass, trees, and a fishing pond.)

For purposes of real estate investment, however, this type of property is typically bought to buy and hold as is, to build a new home on the property, or to subdivide the property into individual lots and develop it with brand-new houses.

Acreage that is being held and not being improved by adding a house to it requires some special financing, and there aren't too many avenues of finance from which to choose. Such land is usually more than 25 acres and is outside of a city or town.

Raw land also doesn't change hands very often. It's not like a four-bedroom duplex right next to a college dorm, where there might be a lot of demand for it. People generally buy homes more often than they buy unimproved property.

Raw land can also be more difficult to evaluate from a lending perspective. Because such large acreage purchases don't happen very often and are by their nature remote, lenders can't compare similar sales as easily as they can do with houses.

In fact, most lenders who do finance raw land won't touch it unless it has already been subdivided and has utilities in place. This also means that such loans are short term, such as 12 to 18 months, while the land is awaiting a new home to be built on top of it.

If the raw land has no such plans or utilities in place, it's perhaps one of the most difficult pieces of real estate to make a loan on. If the buyer goes bad on her loan and the bank is forced to take the land back, it is often sitting on a white elephant that it can't get rid of.

To offset such risk, a raw land lender will ask for as much as 50 percent or more down before making a loan decision. If there are development plans in place, then that down payment requirement can be lowered significantly to closer to 20 or even 10 percent, given a strong borrower.

Still, if the land doesn't appear to have any development potential, the bank is lending more on the strength of the borrower and much less on the asset.

Another consideration regarding raw land is that it's usually surrounded by other raw land. That means that if you want to sell the acreage to a potential buyer, then your offer will have to be better than all of the other raw land deals that surround you.

If you're going to develop the land by putting in utilities and roads and subdividing it, then that's a different story and becomes easier to lend on, but if you're buying raw land as speculative, then be prepared to put a lot of money down for it relative to the sales price and have lots of patience.

This is definitely an investment that you should plan to hold for a long time.

New Construction

New construction investment can be in the form of financing the costs of building the unit itself, such as hammers, nails, paint, and labor, or financing that includes not just those items but also the acquisition of the lot as well.

This form of investment property may or may not have a buyer when the unit is completed. If it does not, the investment can be called purely speculative, or a "spec" home.

If you own the land that the home is going to be built on and you get construction financing for the house, the lot that you own is automatically considered your equity in the deal, meaning that when you apply for a construction loan that requires a 10 percent down payment, instead of your bringing cash to the table, the construction lender will use the value of the lot as your down payment.

Let's say you get some bids to build a 3,000-square-foot home on a half-acre lot that you own. The lot is worth $150,000, unimproved.

Bids to build the house come in right around $1.50 per square foot, or $450,000 in value when the home is completed.

By adding your lot value of $150,000 and the completed value of $450,000, you have a total value of $600,000. If your construction lender is requiring a 20 percent down payment to finance your construction, 20 percent of $600,000 is $120,000, so you've already covered that down payment requirement through the $150,000 equity position you have in the lot.

That's assuming that you own the lot free and clear. You must deduct any notes due on that lot to determine your finished equity. If your lot is valued at $150,000 and you have a $50,000 note against it, your equity position is only $100,000.

Therefore, if the construction lender requires 20 percent down on that same deal, you still need $120,000, but you have only $100,000 in lot equity, so you will in fact need to come to the construction lender with another $20,000 to get your construction loan.

Construction lenders value new construction using an "as built" approach. There really is no value in the home—not much, anyway—until it's finished. When a bank makes a determination of the value of your home and how much to lend on it, it sends an appraiser out to the job site with a set of plans; the appraiser then makes a value determination based upon the house being completed, and the bank issues a construction loan based upon the house being already built.

When the home is finally finished, the bank will send the appraiser out one more time to make sure the house is finally 100 percent complete. At this stage, when the home is finished, you will need to get a permanent mortgage to replace the construction loan. Note that the term *permanent* doesn't necessarily equate to "long term"; it means only that its job is to replace the temporary construction note.

Construction loans are short term and cover only the hard costs of building and soft costs such as building permits and inspections. At the conclusion of construction, a permanent mortgage will replace the shorter-term note.

That is, unless you've already sold the property while the house is being built and so won't need permanent financing. If you haven't found a buyer for your spec house, then you'll need to arrange some sort of financing to hold onto the property while you're trying to sell it.

In the case of spec houses, you really need to have your ear to the ground. When you start construction, depending on the type and size of the house, it could be a year out before it's done. You need a pretty good crystal ball for that.

And you may also need some experience with spec houses in the past before a bank will finance one for you. The bank doesn't want the spec house. If it did, it would build one of its own. The bank wants your money.

When you build on spec and you are an investor, you can anticipate making a higher down payment in the form of lot equity or cash and potentially paying a higher interest rate associated with non-owner-occupied properties.

Investment Property Versus Second Homes

There is a clear distinction in lending between investment properties and second homes in terms of classification of occupancy type. When you complete a loan application, one of the areas it asks you to complete is whether or not you're going to live in the property as your primary residence . . . your home.

Occupancy is one of the risk factors that lenders use to evaluate a loan. The three occupancy classifications are primary, second home, and investment property. Investment property is considered to have the highest risk of default to a lender of the three types.

A second home is considered the second of the risk groups, and the primary home is considered to have the lowest risk. The difference between a second home and an investment home is usually about 3/8 to ½ percent in rate, or about 1.5 to 2.00 points.

On a $400,000 deal, 2 points works out to $8,000. Or an increase in rate of ½ percent means that that same $400,000 loan went up about $125 per month, every month. Over the course of a 30-year loan, that's a lot of money—about $45,000.

A second home is a home that is not rented out by the owners but is used as a vacation home or a getaway spot for the owner. A second home is typically out of the immediate geographic area and is often in a vacation or resort spot, such as in the mountains, on the beach, or stuck far away from civilization.

An investment property is a rental. It can be in a vacation area or in the mountains, but from a lender's perspective, if the property is rented out more than two weeks during the entire year, the home isn't considered a vacation or "second" home but is a rental. That means higher rates, perhaps a larger down payment, and higher costs.

How does a lender determine whether the property in question is a second home or an investment property? There is no exact formula, but the underwriter who reviews your loan will use a little common sense.

If the property is across town, then it's not a vacation home. There is no reason to go on vacation to get away from it all if it only takes a 30-minute cab ride. If the property is in an area where the underwriter feels it's "just not right" that someone would have a second home, he'll ask questions.

If you live in Tulsa and you want to buy a second home in Little Rock, you may need to provide an explanation letter that says something like, "We love Little Rock and always enjoy making the short drive to Hot Springs to watch the races."

But that still might not pass muster. If the underwriter sees that the property you're going to buy is occupied by renters and not the owners, then you may find that the underwriter will have a little squabble with you.

Second homes make more sense if you live in Sioux Falls and are buying in Corpus Christi, Texas, or if you live in Phoenix during the winter and spend the summer in Colorado.

When you are dealing with an underwriter, the burden of proof is on you—the underwriter doesn't have to make the case.

In fact, lenders can actually send a representative to the property after the loan is closed and knock on the door and see who answers. If it's not you, and it's renters, you're busted. The lender has the right to call in your loan. Don't try to disguise an investment property as a second home; it can get you in trouble.

When lenders face additional risk, they offset that risk with other factors, such as a higher down payment (equity from the borrower), higher rates, or some combination thereof.

This is because if a borrower who owns three properties, an investment home, a vacation home, and a primary residence, falls on hard times, the lender knows it's the primary home that will be the one she holds onto.

A rental property could be sold or even foreclosed on before someone will let go of his house or second home.

Even when refinancing a second home, the underwriter can ask for tax returns and look for "rental income" on those returns to determine whether the property is indeed a vacation home or a rental.

Real estate investment property and a vacation home are two distinct types of investment, and lenders will pay close attention to how you check the box on the application that asks which type of property you're buying and getting financing for.

Single-Family Residences

A single-family residence (SFR) is a house. No, it doesn't have to have a family in it, but that's the definition of a house from a lender's perspective.

This type of property is eligible for the best financing terms. Although an investment property will have a 3/8 to 1/2 percent higher rate than a primary residence, it will still have better mortgage terms available than most other property types.

This type of property is the easiest to qualify for a loan on, easiest to underwrite a loan on, and easiest to sell when you are ready to do so precisely because there are more of these properties than any other type and almost every mortgage program designed for residential real estate uses the SFR as its standard collateral model.

When you see interest rates advertised in the newspaper or on the Internet, they are for this type of property.

Duplexes

A duplex is two separate units that are connected. Each side has its own living areas, kitchen, bedrooms, and baths and has a separate entry. The units are also almost always metered separately, but they don't have to be.

Separate metering allows you as the landlord to have the tenants pay their own utilities instead of you paying the utilities for them. There really is no way to discover who is using more water or who is using less electricity if the duplex has just one meter for each utility.

A duplex enjoys the same mortgage choices as a single-family residence does. You can also rent out one side of the unit and live in the other, meaning that the renter next door is typically making your house payments.

For example, suppose a duplex sells for $185,000. Using a 30-year fixed rate at 6.50 percent and 20 percent down, the monthly payment would be $935, plus taxes and insurance.

By renting the other half of the duplex for $1,200 per month (assuming market conditions support that price), you're living on the other side of the duplex mortgage-free—at least as long as you have a tenant next door and as long as she's paying you on time every month.

There's one difference between SFRs and duplexes: Whether you live in one of the sides or not, the duplex will usually be priced as an investment unit, meaning that your rate will be 3/8 to 1/2 percent higher than if you bought a SFR and lived in it.

It may not seem fair to charge you investment rates while you're living in the property, but that's how these loans are priced.

Another feature of a duplex is that the maximum conforming loan limit is higher than for a SFR.

Any loan amount above the conforming figure is called a "jumbo" mortgage and typically carries an interest rate about 1/4 percent higher than conforming loans.

However, a duplex has a higher loan limit to still be conforming, about one-third higher than the SFR limit. These limits will change each year, based upon the previous year's increase in average home prices.

Triplexes

This is the same idea as a duplex, only there are three connected units and not two. Just as the conforming loan limit increases with a duplex, it also increases with a triplex by about another.

Fourplexes

This is the same idea as a duplex and a triplex, but with four attached units and a higher maximum conforming loan limit at $801,950. Often a triplex or a fourplex can be called a 1–4-unit structure yet still have only three or only four units.

Multifamily Properties

A multifamily project is five or more units, but it is most easily described as an apartment complex. Instead of getting financing for each individual unit, you will invest in the entire apartment complex.

Depending upon the sales price of the apartment building, you may be able to get financing just as you would for any other residential real estate by completing a residential loan application. Normally such loans will cap out at $1.5 million, and the lender will ask for a minimum of 20 percent down.

If you want to borrow more than $1.5 million, then you'll step out of the residential mortgage arena and straight into commercial financing packages.

Commercial Financing

Commercial financing for residential real estate typically requires 20 percent or more down; the terms are typically three, five, or seven years and are based upon the prime rate plus 1 to 3 percent. There is also an additional aspect of commercial financing called the debt service coverage ratio, or DSCR, which is calculated this way:

DSCR = net operating income ÷ debt service.

Debt service is the principal and interest payments on the note used to buy the apartment. Net operating income is the income minus all expenses associated with keeping up the building (net income). Therefore, the DSCR is net income divided by the mortgage payment on the loan.

The required DSCR is normally 1.2 to 1.3; it is rarely below that. A number above 1.0 represents a positive cash flow. If the DSCR is 1.3, then for each dollar of the mortgage payment on an apartment project, the prospective lender wants to see an additional 30 cents in net operating income.

Commercial financing is underwritten using entirely different formulas and is reviewed by commercial loan officers.

If the apartment complex you want to buy costs $1.5 million or less, then there are loan programs based more closely on the individual, just as with any other residential real estate loan.

Condominiums

A condominium, or "condo," is a structure in which the owners own the interiors of their units individually and share the outside or common areas with all the other owners in their condominium association.

The most common type of condominium resembles an apartment building, but with the apartments being owned rather than rented. The owners have complete control of the interior of their unit, but everything else is commonly owned.

If there is a common area like a swimming pool or a workout room, then all the tenants own an equal part of that swimming pool or workout room. Condos can be large or small, and they can be attached to one another like apartments are or be detached units that don't share the same walls.

Condos are governed by a Homeowners' Association, which sets certain bylaws that condo owners are expected to follow.

Condos are divided into two types: warrantable and nonwarrantable.

A warrantable condo means that it meets the property guidelines established by Fannie Mae, Freddie Mac, or the Federal Housing Administration (FHA). Fannie Mae is the nickname for the Federal National Mortgage Association (FNMA), and Freddie Mac is short for FHLMC, or the Federal Home Loan Mortgage Corporation.

Fannie Mae and Freddie Mac are entities owned by the federal government, yet they are publicly traded on the stock market. The purpose of each of these government-sponsored enterprises (GSEs) is to provide liquidity to the mortgage market. We'll examine why this is important in more detail in Chapter 5, yet a condo that is warrantable meets these guidelines.

This makes the loan terms more favorable. A nonwarrantable condo is a condo that does not meet one or more of Fannie Mae or Freddie Mac's condo requirements.

A warrantable condo is one where:

All phases have been completed.

The common areas are 100 percent complete.

Ownership has changed hands from the developer to the Homeowners' Association.

No one individual owns more than 10 percent of the project.

The condos are occupied primarily by the owners.

A nonwarrantable condo means that one or more of these requirements has not been met.

All Phases Have Been Completed

A condominium project can be built in phases. Instead of building 300 units at the same time, a developer could build the units in phases. In new construction, no one can move into a unit until that unit is completed. When an SFR is done, the owners can move in or rent it out, but not until it's 100 percent complete.

If a builder waited until all 300 units were complete, he would have to wait a long time to get his money back. Instead, he may build in phases, with 100 units being completed in Phase 1, 100 more units in Phase 2, and finally another 100 units in Phase 3.

This way he can build and sell, build and sell. For a condo to be warrantable, all phases must be completed. To get the very best lending terms, the buyer of a condo might have to wait until all phases are done in order to qualify for a Fannie Mae or Freddie Mac loan.

Common Areas Are Complete

The common areas are the sidewalks, the parking lot or garage, the landscaping, and even the pool or workout facilities. Common areas are owned by all the tenants equally and are kept up by the Homeowners' Association using the dues paid by the owners to the Homeowners' Association.

All common areas must be completed before a condo can get warrantable status. Confirmation of 100 percent completion comes during a final inspection done by your appraiser. Sometimes your condo may be done, but these areas aren't complete.

But before a condo is warrantable, the appraiser must verify that everything has been completed according to building specifications.

Ownership Must Change Hands From the Developer to the Homeowners' Association

During construction, the developer owns the project and controls its daily operations. But once the units have been completed, the developer must legally transfer the ownership to the homeowners.

No Single Entity Can Own More than 10 Percent of the Project

If there are 100 units, no one person or business entity can own more than 10 units. Again, the appraiser will typically ask the Homeowners' Association for this information and verify its accuracy. One of the association's many functions, especially early in a new condominium project, is to complete these homeowners' questionnaires for prospective lenders.

Most Units Are Occupied by the Owners

Finally, a warrantable condo project is primarily owner-occupied, meaning that while there may be renters in the condo project, they must make up no more than 40 percent of the total number of units.

If any of these conditions are not met, the condo is nonwarrantable. The condo could have every other warrantable property, but if the ownership hasn't legally changed hands from the developer to the Homeowners' Association, then everything stops. This doesn't mean that you can't get financing on your investment condo; it simply means that you can't get conventional financing.

Another way to get competitive financing is if the units have been approved by the Federal Housing Administration. The FHA has its own condominium guidelines, and if the project has been audited and approved by the FHA, then the condo automatically qualifies for FHA pricing, which is just as competitive as conventional pricing on Fannie Mae and Freddie Mac loans.

If you're looking to invest in a condo project and want to know if it's been approved by the FHA, the listing agent will typically have that information. If not, the Homeowners' Association will have it, and if you're still running up against a wall, the FHA has a special web site listing FHA-approved condominium projects at https://entp.hud.gov/idapp/html/condlook.cfm. Simply search for a particular condo project or by state or by address.

Nonwarrantable pricing is higher than warrantable, often nearly 1/2 percent higher than a conventional or FHA mortgage product, and this can make a real difference if cash flow is tight for a particular investment.

There is a way to turn an investment condo into a primary residence condo, allowing you to get the best terms available, but this works only when a family member will be living in the unit and will also be on the note and on title. This is sometimes called a "kiddie condo," where mom and dad buy a condo and put their son or daughter on the note as well as having him or her live there.

This is a very popular structure in college towns, where students can live in property their parents own while they go to college, then the parents can either sell the condo for a profit when the student graduates or keep the unit and continue to rent it out.

This strategy will usually work only with FHA loans because most other loans require a review of the employment, credit, and debt ratios of the person occupying the condo. Conventional lending on a kiddie condo will work, but only if the student can show some income and meets certain ratio requirements along with mom and dad.

Often the problem is that the student doesn't make enough money to help with the mortgage payments. If the student is working part time and makes about $300 per month and the condo payments are $2,000 per month, then it's doubtful that a lender will allow the student to go on the note in order to get the more favorable owner-occupied rate.

That's not the case with FHA loans, as there is no requirement for the owner-occupant (student) to show income to help qualify, as long as the student goes on the note and title at the same time that mom and dad bought the condo.

If you want to explore this option, first visit the FHA web site that lists FHA-approved projects, then take the next step about qualifying. This is by far the most popular method of kiddie condo financing.

Note: To have received FHA approval, the units must also be warrantable under conventional standards. The FHA doesn't warrant properties much differently from Fannie Mae or Freddie Mac, yet its owner-occupant guidelines are different for purposes of loan terms.

You can also make an investment property out of an owner-occupied property if you move into it first, then move out later if that's what you decide. If you decide to move to Lincoln, Nebraska, and you buy a house, move in, and work, then that's an owner-occupied home.

If later you decide to move out but keep the property, the lender doesn't call you back and make you pay a higher rate just because you moved out. In fact, many people actually get started in real estate investment under such circumstances. By accident.

Say you bought a house and lived in it for a while, and then you either got transferred or decided that Lincoln was too cold in the winters for you, so you think about selling. But either you can't get the price you want or you can't sell fast enough or you simply want to rent out the house, thinking that one day you might move back, so you keep the house and rent it out instead, moving on to a warmer climate.

Suddenly, you now own investment property at owner-occupied terms. You're not obligated to redo the entire loan to make it an investment property. You simply moved out.

One thing you cannot do, however, is move in, then move out the next day. Or the next week, or maybe even the next month, for that matter. When you check "owner-occupied" on your loan application, your new lender will soon verify that you in fact do live there after you close.

If your unit is rented out to someone else, the lender could call in the note and redo it. You fibbed in order to get a better rate. However, if you can prove that you fully intended to live in the property, but external forces such as a job change or illness or some other emergency forced you to move, you could claim a hardship.

Turning owner-occupied property into investment property is usually not something that's planned; it's just something that happened later on down the road.

Unusual Properties

Finally, the last type of properties to invest in are ones that I call "weird" properties. This can mean a property that is physically different in type or one that is dissimilar to other properties in the area, or both.

Got a good deal on a geodesic dome? You know, those weird-looking things that look like a geometry set gone bad? Did you fall for the salesman's pitch that geodesic domes provide more comfort and more space and last longer than traditional homes, and they're the wave of the future? Typically the future hasn't arrived, and your real estate investment may hit a snag if the lender you want to have finance the property can't finance it because yours is the only geodesic dome in the neighborhood.

Lenders like a certain level of conformity. Conformity shows that there is a demand for a particular type of property, and if there's a demand, then if the lender ever has to take back the property, there's an apparent market for it. It "fits in."

Geodesic domes don't fit in. In fact, the only place they fit in is someplace where there are lots of other dome enthusiasts. That's where you're most likely to find domes: with other domes. Even then, lenders will balk. You can get financing on domes, but not the best. There's just not enough demand for them to command a competitive mortgage rate. Log cabins? See geodesic domes.

Unusual properties don't necessarily have to be physically all that different; it's just that there aren't exactly similar sales in the area.

I financed an entire subdivision for a builder who had gotten himself into hot water. He had an idea for building some unique student housing in a college town that would be inexpensive to build and inexpensive to buy, and that would generate cash flow for his investors immediately.

He drew up plans, made the pitch to his bank, and got a construction loan to build these new cash cows. The concept was brilliant: He designed four-bedroom houses where each bedroom had its own bathroom, but they shared a central living area and kitchen.

The buildings were very much like dormitories, but with only four units. The demand for student housing was there, as this college was booming and was running out of space for its students, and most of the available housing was either older apartment dwellings or single-family houses.

Now, four students would pay rent on one house and live in a brand-new neighborhood instead of in some tacky old apartment building. In addition, the builder constructed these units more cheaply by using modular housing instead of traditional "stick-built" houses.

Modular housing meets the very same building code standards that regular housing does, yet the "parts" are built off-site and put together on-site. The walls, the roofs, and the bathrooms are prefabricated—everything is prebuilt at a factory.

The houses looked the same and were built the same; the only differences were the color of the houses and the roof. Other than that, they were identical, built from materials that had already been made at a prefab factory.

In other words, they were extremely cheap to build, yet they still met the same rigorous building codes as a standard house. Not to be confused with manufactured housing, modular housing provides value with solid construction.

The builder pitched his project to different people he knew, and the units were 100 percent sold before construction ever took place. It was a real "no-brainer."

He completed the project and began to transfer ownership of the houses to the buyers. There was one big problem, though: No one would lend on them. No one could get financing. He was stuck. The bank wanted his money, but he didn't have it—it was tied up in his modular home project.

Why would no one lend on these houses? They were weird. They were four-bedroom, four-bath houses (that's different already), and they also had a unique construction: modular. Okay, they weren't weird in the literal sense; they looked like any other house, only nicer because they were brand new. There simply were no other houses in the area that would be considered similar to these units. There were no comparable sales, or "comps." There were absolutely zero four-bedroom, four-bath houses with one central living area built entirely using modular construction.

So the developer called me on the phone one day: "David, I need your help."

We met for lunch, and he showed me his plans. He had contracts for 48 houses at $125,000 each, and he couldn't close on any of them.

I reviewed the project and came up with a plan. We found one person who would pay cash for his unit; that gave us a comparable sale inside the new development. Next, I found lenders who would make loans for modular housing. Then we closed four of these loans with one lender before we went on to the next lender. Why did I do that?

It's an investment term called *exposure*. A lender will not lend on more than 10 percent of any new development. We had to go to a different lender each time we closed four deals.

And because these units were a bit out of the ordinary, I used alternative, or "alt," financing. Alt financing is typically anything that is not conventional or government; it is used to make loans on properties that Fannie Mae, Freddie Mac, or FHA won't do.

These loans are made under different terms, mind you. Typical alt financing can be between 1/2 and 1 percent higher than the rates reserved for conventional products. The developer almost lost his entire development to his bank before he got his financing arranged.

You need to pay close attention to what available financing packages, if any, are out there that you can use. If there aren't any, regardless of how enticing the investment is, you won't get financing for it, and you must either pull equity out of other properties or pay cash.

In general, rates can change depending upon property type, as indicated by this chart.

Property Type	**Base Rate**	**Min. Down**
SFR	6.25%	0%
SFR rental	6.625%	10%
Duplex	6.625%	10%
1–4 units	6.625%	20%
Kiddie condo	6.25%	0%
Investment condo	6.625%	10%
Alternative	7.25%	10%
Multifamily*	10.25%	20%

*Based upon a *Wall Street Journal* prime rate of 8.25 percent plus 2 percentage points.

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CHAPTER 3

The Players

More than ever, the people and players you associate yourself with both during your property search and throughout your loan closing can affect the profitability of your investment.

It's critical that you know not just who each of the players is, but who each one is in relation to your investment. Some you can negotiate fees with, while others will be an integral part of your real estate team, helping you to find and acquire the right property while still making the numbers work. After all, that's what it's all about, right?

We'll identify the various people in the real estate transaction, explain their function, note their average costs, and label them "critical," "important," or "necessary."

Critical Players

The Lender

This is where you get the money; it is obviously a critical piece of the transaction. But going to your lender doesn't necessarily mean that you'll automatically get the best deal; your best deal may not come from a lender at all, but could very well come from someone who doesn't make the mortgage but simply arranges the financing for you. This person, a mortgage broker, has the ability to search various lending programs for you to find the most favorable financing terms that meet your requirements.

There are two basic sources of money: mortgage bankers and mortgage brokers. Mortgage bankers are entities that lend their own money, while mortgage brokers do not lend their own money but find money for you.

Mortgage bankers come in all shapes and sizes. Every retail bank you see on the street corner has a mortgage banking operation. A bank may not only have your checking account, your car loan, and your credit card (all different divisions of the same bank), but also have a dedicated business line that makes mortgage loans, collects the mortgage payments, and performs other mortgage-related functions. Mortgage bankers approve the loan directly and typically have a bit more latitude when they make a lending decision.

On the other hand, a mortgage broker may have a particular advantage in the mortgage world: choice. Almost every bank and mortgage company you've ever heard of (and plenty more that you haven't heard of) operates a wholesale mortgage business. A wholesale mortgage business works a bit differently from a retail mortgage lender in that a wholesale lender's customer is not the buyer but the mortgage broker.

Wholesale lenders have account representatives, or salespeople, who do nothing but call on their various mortgage brokers and get more mortgage brokers to do business with them.

When you walk into a bank or a mortgage company, you'll notice lots of employees, desks, telephones, and light fixtures, and there will also be things you won't see, such as wages, insurance coverage, and employment taxes. These are hard costs, costs that a mortgage company must pay while still making a profit doing so if it wants to stay in business very long.

Wholesale lenders, while they have employees, do not set up offices that take loan applications from consumers. Instead, they visit mortgage brokers, who already have offices and employees and all the other associated expenses of running an office, and find brokers who will market their mortgages for them.

In return, the wholesale lender offers the mortgage broker a reduced rate on its mortgage programs, which the mortgage broker "marks up" to retail level. Therefore, a mortgage broker is not necessarily more expensive than a mortgage banker, although it can be if the broker marked up the mortgage too much.

A typical markup from wholesale to retail is about 1/4 percent in interest rate or about 1 discount point. A discount point, or point, is 1 percent of the loan amount, or $2,000 on a $200,000 loan.

Wholesale lenders compete for the mortgage brokers' business just as lenders compete for yours. Each day, wholesale lenders compile their rate sheets and e-mail or fax them to their mortgage brokers. Each day, mortgage brokers review those rate sheets trying to find the absolute lowest interest rate for that day, hoping to find the best possible deal for their borrowers.

Another distinction a broker has is the ability to not just compare mortgage rates but also find unique or niche mortgage loan programs that not all lenders have. A lender could offer a special program for investors that requires zero money down. Not many lenders offer such a program; in fact, there is no conventional or government product that offers such terms. But there are programs that do just that.

A mortgage broker can search through his bevy of lenders and find a mortgage program that not many of them have. In fact, if you see advertisements in the newspaper or on the Internet showing loan programs that seem a bit unusual, they're probably from a mortgage broker.

Not only do brokers attempt to find you the best rate, but they may also help you find a unique program that fits your requirements, as I was able to do for the modular condo investor mentioned in the last chapter.

Note: If a mortgage broker does find a zero-down investor loan, it has to get that loan from a wholesale lender. And if it gets the loan from the wholesale lender, you can bet that the wholesale lender's retail mortgage banking operation has the exact same zero-down program.

The advantage for you is that you don't have to make phone calls all day long or search the Internet for unique loan offerings; a mortgage broker does that for you and most likely knows exactly where to get niche products with little effort, all at competitive prices.

That's why, depending upon which source you use, mortgage brokers originate about two-thirds of all mortgage loans today. That's a lot, and it's a huge leap from when mortgage brokers first became mainstream in the early 1990s.

Bankers, on the other hand, offer more control over your loan. That means that when problems arise, the banker can address those problems directly without having to go through the various channels that a broker must use.

Bankers can make lending exceptions on loan files, exceptions that might mean stretching a lending requirement. Bankers are also more advantageous when it comes to "hands-on" loan programs such as renovation or construction loans.

During the process of a remodeling or new construction, lenders do periodic reviews of the progress of the property before doling out additional construction funds to the builder as the work progresses. Mortgage brokers won't be around for that; they're off getting other loans.

Bankers can also be just as competitive as brokers can, generally anyway. I've been both a mortgage broker and a mortgage banker, and I enjoyed being a broker, but I really enjoy being a banker primarily because it gives me the ability to step in when a mortgage problem arises and take care of the issue directly instead of passing the problem up the ladder and waiting for someone else to fix it.

There is one more possibility: a mortgage banker that also acts as a mortgage broker. For an investor, this is quite possibly the best of both worlds. A banker can lend out of the bank's own funds, approving loans using previously approved lending guidelines, but if an investor needs a mortgage program that the banker doesn't personally have, the banker can also find other wholesale lenders he is already signed up with and use their products to fund the loan.

I recently closed a loan for a client in Austin, Texas, who wanted a zero percent down investment condo. My conventional loans via Fannie Mae, Freddie Mac, or FHA didn't offer such a product, but another wholesale lender I use occasionally did offer it. I simply sent the loan package to the wholesale lender, and it approved the loan.

National mortgage bankers won't also broker. If they can't do the deal, they'll either try to talk you into something else or pass altogether. If you want a banker who is licensed as a broker as well, you're looking for a local or regional mortgage banker.

It's difficult, if not impossible, to tell whether someone is a banker or broker just by the name. Many names, such as First Southwest Capital, could be used by either a mortgage banker or a mortgage broker. Often you must simply ask the company whether it's a banker and whether it also brokers when needed.

States have different licensing requirements for mortgage brokers and mortgage bankers, so you can log onto your state's web site, search for mortgage licensing, and look them up. However you find out, finding a mortgage banker with broker capabilities is a pretty strong start.

When you find your lender of choice, keeping that lender in your portfolio helps you when you find additional properties that you want to buy. Often, lenders can simply open up your old loan file and copy some of the old data into a new loan application for you to sign. This is much easier than applying over and over again each time you find a property that you want to buy.

You're also establishing a long-term relationship that's built on trust. When you have such a relationship, you can spend less time searching for the ideal loan and more time on finding ideal properties to buy.

Mortgage lenders get paid as a result of their loan officers finding mortgage loans, and they split the loan proceeds with the loan officer. A typical commission on an individual loan is somewhere between 1 and 2 percent, and the lender and the loan officer will divvy that up between themselves.

Mortgage lenders also make money by charging you "junk fees," which can range anywhere from $300 to $1,000 or more. We'll discuss closing costs and loan fees in more detail in Chapter 6.

The Loan Officer

Your lender will also be the employer of your loan officer. Whether you are using a mortgage broker or a mortgage banker, it's your loan officer who will work with you in finding the proper mortgage. You're not working with a mortgage "company"; instead, you're working with a person who either works for or owns that mortgage company.

Your loan officer will quote rates, quote fees, compare programs, and identify lending opportunities that you may not be aware of. Your loan officer will be your most trusted financial adviser as it pertains to financing real estate.

A bank, a mortgage banker, a credit union, and any other mortgage company is only as good as its front-line people—the loan officers.

This can be particularly true of major mortgage bankers and retail banks that advertise heavily, touting their neat investor loan products. It really comes down not necessarily to the bank, but to the experience of your loan officer.

It's critical that you choose a good lender. It's also critical that within that lender, you choose an experienced loan officer and stick with her.

Think about that for a second. You walk into your bank or credit union or your favorite lender's web site and see all these great ads with cool marketing phrases and just the right colors to make you want to do business with that mortgage company.

But guess what? All those posters in the lobby or the online ads are worthless if your loan officer doesn't get the job done.

A bank can have the biggest advertising budget in the world but also have a bunch of rookies who do nothing but take loan applications and have little experience in mortgage lending.

The lender is the one who holds the purse strings, approves the loan, and issues your closing papers. Lenders may lend locally, across the state, or across the country.

Because of state and federal lending laws, a company that lends nationally is typically a federally chartered bank or a mortgage banking operation with licenses and operation in all 50 states.

If you invest locally, or at least in your own state, then almost any loan officer can help you. If, however, you want to broaden your horizons and invest in other parts of the country, you'll want to find someone who can lend pretty much anywhere.

You won't always be that lucky, but that's the ideal: to find one loan officer who can work with you anywhere.

I recall a client who lived in California and wanted to purchase an apartment building in Galveston, Texas. He called me; I said I could do what he wanted. He also had some properties in Texas that he wanted to refinance; I could do that also.

Then he asked about Nevada, because he had some stuff that he needed help with there also. And Hawaii. I wasn't licensed in Hawaii and couldn't help with that, but I could help with Nevada. So he contacted another mortgage company that was licensed to lend in Hawaii.

That meant that he had to have more than one application at different lenders and had to provide duplicates of everything to both me and his Hawaii company. Had I been able to lend everywhere, he wouldn't have had to duplicate all of his efforts and could have established a working relationship with just one person who had his personal goals in mind. But it doesn't always work out that way.

There is one other difference you need to be aware of: Loan officers get paid differently at different lending institutions.

Mortgage brokers work for themselves. Or at least they're loan officers who work at a mortgage brokerage operation and typically lend only in their state. Mortgage bankers also work for their company and can often lend in their state and perhaps a few others.

Do your homework and try to find a loan officer who can meet your investment requirements while always being on the lookout for your mortgage fitness.

Mortgage fitness can mean refinancing when the time is right. Or a new loan program may become available that you need to be made aware of. You're investing in real estate, not investing all your time in keeping up with mortgage rates on a daily basis. A trusted loan officer will do just that for you.

If your investment goals take you beyond your local borders, then in a perfect world, finding a loan officer who can lend anywhere you want to buy is a plus.

The Contractor

When you find a property that you want to rehab, the contractor is a key element; he provides advice on how much your project will cost and how long the remodeling will take.

Finding a good contractor is done through referrals, and fortunately, when researching a contractor, his abilities are easy to discern from the work he's done on other properties.

Begin by asking friends, family, your lender, your Realtor, or anyone else you know who might have had experience with remodeling or who knows a contractor firsthand.

You want your contractor to be able to not only provide quality work but also perform that work within the specified time frame. Time is indeed money, and if you go past a projected completion date, you'll be paying another month's worth of interest charges that you didn't anticipate, eating into your profit margins.

You also need someone who can accurately predict how much a project will cost. If you budgeted $10,000 for a bathroom remodeling and it comes out at $13,000, then you're again losing income.

Your ideal contractor will be able to provide accurate quotes on both time and expense as well as be able to begin and finish as planned. Often you'll find that good contractors are booked up way in advance of when you need them. Apparently they're good enough that their schedule is packed solid for several months, so you need to look elsewhere.

Once you do find a contractor that you can count on, you should do whatever you can to keep her in your camp, and in yours alone.

The Realtor

This person's job is to find properties that fit your criteria. And let me add one important point here: Realtor is a licensed trademark of the National Association of Realtors. Someone who gets his real estate license and becomes an agent is not necessarily a Realtor.

A Realtor is someone who is a member of the National Association of Realtors and who adheres to its strict code of ethics. A Realtor is a dedicated professional. I'm not saying that someone who is not a Realtor is not dedicated, just that agents who are Realtors have pledged themselves to a higher level of education, professionalism, and ethical business practices. Use a Realtor and not just a licensed agent.

Or more specifically, use a Realtor who represents you, the buyer. The listing agent is the one who puts the property up for sale. The listing agent is not on your side; the listing agent is on the side of the seller. You want a buyer's agent when you're purchasing properties.

You can certainly begin buying investment properties on your own, and in fact that might be how you buy your first property, but you won't have the access to new properties that become listed that a Realtor does.

Properties are typically listed in a system called the Multiple Listing Service, or the MLS. The MLS is a database where Realtors share information about new properties for sale.

I recall that many years ago, when my mom was a Realtor, agents would keep their own listings on index cards or in a property book. As

Realtors went out and found properties to sell, they would enter those properties in the listing book or write them down on cards.

Each week, various Realtors would meet over coffee or at a lunch or a business meeting and share their new listings with one another. It would go something like this:

"I have a new three-bedroom house on one-half acre that is all brick and has a brand-new pool. The owners are asking $49,000 for it, and it was just listed last week."

Remember, there was no such thing as the Internet back then, right? Eventually, though, personal computers became more common, and the property information was kept in a centralized database and accessed using DOS-based programs.

Nowadays, the database is on the Internet, and as Realtors post new listings, they become available to other Realtors almost immediately. In fact, some Realtors' web sites let you key in your search parameters and will notify you when properties that meet your needs are listed.

You can certainly start this way, but solely from a property search standpoint, it's the Realtor who can sniff out potential listings before they even come on the market. That's one of his jobs, the good ones anyway.

Good Realtors are constantly searching for new listings; that's where real estate really gets started—by finding people who want to sell. You need a good Realtor who is always on the lookout for potential investments that fit your profile.

For instance, you may have determined that you want to invest in a town where you know that the local chamber of commerce has been courting major industry for the past couple of years. You decide that it would be a good time to invest in single-family houses designed for people who will transfer into that area.

You tell your Realtor that you're on the market for three- or four-bedroom houses, about 10 to 15 years old, and under $185,000 where you could get some serious cash flow from renting them.

A Realtor becomes your bloodhound, looking for properties that come up before they ever hit the market. And that's what you want. A Realtor will scour the neighborhood you're interested in (and surrounding ones) for three- or four-bedroom homes under $185,000 by sending out mailers, going to functions, and essentially letting the world know that she has a serious (and secret) buyer who is looking to buy—right now.

The clear advantage is that you can find property before it ever hits the MLS. You certainly don't want to get into a bidding war or find a house that suddenly has multiple offers. No, you want your Realtor to find those properties for you. That's one of his jobs. It's a critical function.

A Realtor will also guide you through the negotiation process and help you with your offer. Unless you're a seasoned veteran of the real estate business, the Realtor can help you with an offer, make sure there aren't any "gotchas" in the contract, and help you with other affiliated partners such as inspectors, insurance companies, contractors, and lender referrals (just to name a few).

Your Realtor has his pulse on the real estate community, full time.

When you are buying the property, a Realtor doesn't cost you anything. A Realtor usually gets paid a percentage of the listing agent's commission, so the seller usually pays the Realtor.

When a listing agent lists a home, the seller and the listing Realtor agree upon a commission. For instance, say the seller and the Realtor agree that the Realtor will get 4 percent of the sales price of the home. On a $500,000 property, that would be a commission of $20,000.

The listing agent will put the property in the MLS and will also post what amount of commission she will pay other Realtors who bring a qualified buyer to the closing table. Often this commission is split 50/50, but the split can be just about anything the listing agent and the seller agree upon.

If the listing agent agrees to split her commission 50/50 with another Realtor if he brings a buyer, in this case the buyer's agent (yours) will get 50 percent of $20,000, or $10,000. You don't pay your Realtor to find properties for you; the listing agent does so out of the commission she earned from the seller.

Now, $10,000 is a lot of money, and if you're a serious investor, you can bet that your Realtor will constantly be searching for more $10,000 paychecks—properties for you that meet your exact specifications.

If you consistently use a Realtor to find properties for you, you can also negotiate the commission she gets by having her pay some of your closing costs at the closing table. If your Realtor gets paid $10,000 on each transaction and you've bought five properties in the previous year, then ask what type of contribution she can make toward some of your closing fees, such as inspections, appraisals, or even discount points to buy your mortgage rate down.

If a Realtor is making $50,000 per year from just one client (you), you're certainly within your rights to ask for some help with your expenses on occasion. This is something that's negotiable. It may not always happen, but if you promise all your business to one Realtor, you should expect some discounts. And you can get these discounts when you decide to sell property as well as when you buy it.

When You're Ready to Sell

Unless you're an active Realtor as well, you'll need a solid Realtor to help you when you sell the properties you've invested in.

A listing agent's primary responsibility is to you and you only. His priority is you and finding the best offer for your properties when you decide to cash in. You can certainly sell properties on your own, but if you're not a professional at it, then you need to find a good Realtor.

A listing agent will work with you to determine the potential market value of the property you're going to sell. A listing agent will go to all the Realtor meetings, promote your property to as many eyes as he can get in front of, and attempt to get you top dollar.

Listing agents don't make money until they sell, which is quite a motivating factor. They make their commission from selling your property. Commissions are negotiable and are between you and the Realtor. There is no set standard for Realtors' commissions.

However, when you find a good listing Realtor, you should be able to negotiate a competitive commission if you dedicate your business to her.

You can use the same Realtor for both listing and buying properties. In fact, this might be the best deal of all, as your Realtor will be dedicated to you on both sides of any transaction and will see you as a major income stream. If she messes up, she's lost your business. If, however, she does well, you should keep her.

Your Realtor and you should be the closest of buddies. Find a good one and keep her.

Important Players

Loan Processor

Your loan processor is the person who will shepherd your loan application through the mortgage approval maze. The loan processor works for the mortgage company where you get your loan, but he also works directly for your loan officer.

Your loan goes through a process, from beginning to end. The beginning is essentially when you fill out your loan application, and the end is when money is transferred from the buyer to the seller. A lot happens in between those two points, and it's your loan processor who guides the ship to safe harbor.

Your loan processor will talk or otherwise communicate in some fashion with every single person or party who is involved in your loan application. Who they all are really depends upon which part of the country you live in or the property you're buying is located, but your processor talks to all of them.

The processor will contact your insurance agent for evidence of insurance coverage. Your processor will contact the title insurance agent for title insurance. Your processor will also contact the attorney, the appraiser, the inspector, the surveyor—anyone and everyone who is involved with your loan. Your processor is the person responsible for making sure that your loan has all the required documents included for loan approval.

You need to know your processor intimately. It's your loan officer who finds your financing, but it's your processor who makes sure that everything is in order before your loan goes to final approval from the underwriter.

In fact, once you choose a loan program, your loan officer will most likely be out looking for more business. That's part of her job. But after the purchase contract is signed, it's the processor who will be your new best friend.

When there are loan questions that need to be answered or gaps that need to be filled before a loan is funded, your processor will contact you directly. If there's a question about some tax returns or insurance coverage, you'll be speaking with your processor.

Your processor will work with your Realtor and your attorney and your closer to get your loan documents to closing.

Loan processing fees typically run about $300 to $400 per loan file. You'll pay this charge when you go to the closing table as part of your lender fees. We'll discuss ways to avoid lender fees in Chapter 6.

Appraiser

The appraiser is the person who helps determine the market value of the property you're buying. The appraiser will take a copy of your sales contract and make a physical visit to the subject property.

An appraisal is divided into two basic valuation parts: cost approach and market approach.

The cost approach takes the value of the lot, adds estimated hard costs, typically based upon a dollar amount per square foot, and estimates how much the unit would cost if you built it from scratch.

However, lenders do not rely on the cost approach, but rather on the market approach.

Lenders will review an appraisal to make sure the property they're making a loan on conforms to other properties in the area. One way to make a lender lose sleep is to finance a property that is totally out of step with the neighborhood, such as a one-bedroom, 800-square-foot house that is surrounded by four- to five-bedroom 4,000-square-foot houses.

An appraisal will examine at least three sales of properties in the general area where you're buying that have taken place over the previous 12-month period and compare those sales to your prospective purchase.

Market value, in essence, is the highest price you were willing to pay compared to the lowest price the seller was willing to accept. All other things being equal.

Other things being equal means that the property was not sold under duress, as when the seller wanted to sell quickly to avoid a foreclosure or there was a divorce and the couple simply wanted to get rid of the property at any price.

But without a duress sale, the market forces gather together and form a market price. The appraisal attempts to justify that price based on similar sales in the area.

It's likely that you will never meet your appraiser; you'll only receive a copy of the report. You won't necessarily establish a relationship with an appraiser; those relationships are typically established between a lender and the appraiser.

On the other hand, I know of investors who do call on an appraiser in special circumstances when they have a question about a speculative project. I have an acquaintance who is a builder who builds homes on his own on speculation that he will be able to sell the home for a certain price.

When he wants to know whether a house he wants to build will sell for a certain amount, he'll call his appraisal contact and run the scenario by her. There was a nice big lot here in Austin, Texas, that was in a very desirable location.

The builder wanted to buy the lot, raze the house that was sitting on the lot, build a huge new house, and sell it for about $2.5 million. That was at the high end of anything in the area, as the neighborhood contained lots of smaller, older homes that would fetch nowhere near that amount.

He contacted the appraiser and showed her his plans for building, and the appraiser went to work and decided that, yes, according to his plans and specifications, he just might get $2.5 million. The builder took her advice, built the home, and sold it for $2.3 million.

Your appraiser might also do something that you don't expect: value the property at less than what you offered for it.

Lenders base their loan decisions on the lower of the sales price or appraised value. If you make an offer of $200,000 on a property and it's accepted, but the appraisal comes in at $190,000, then you have an immediate problem.

Because the lender will base its loan valuation on the $190,000 appraisal and not the agreed-upon price of $200,000, it's you who will have to make up the difference. If you wanted to put down 10 percent of the sales price for the loan, you'll have to come in with 10 percent of $190,000 plus the difference between $200,000 and $190,000.

The loan is based on $190,000, meaning that you'll have to come in with $19,000 for the down payment and $10,000 for the difference between the sales price and the appraised value. If, of course, you feel strongly enough to go through with the deal.

Most contracts that you offer (and you need to make sure that this wording is in the contract) state that the deal is off if the appraised valued does not meet the sales price. This gives you an out if the appraisal comes in low.

On the other hand, if the appraisal comes in higher than the sales price, you don't automatically get the increased equity. If you bought the home at $200,000 and the appraisal comes in at $210,000, don't get excited. While it's nice on paper, your loan will be based on the $200,000 figure.

On another note, that value will remain in play for at least the first year of ownership. You can't buy a property for $10,000 under the appraisal, then refinance a few weeks later and pull equity out of the property based upon the higher appraisal number. Lenders will require that the lower of the appraised value or sales price be the determining loan value for at least one year.

When either of these events occurs, there's something amiss somewhere. If your appraised value comes in too low, then perhaps you paid too much. If it comes in too high, the seller didn't sell for enough (and you win!). Such variances occur only rarely, but they do occur; you just have to know that from a lending standpoint, the appraisal attempts to support your contract using comparable sales in your area.

Appraisals cost $350 for loans around $500,000 and more for properties that sell for more than that.

Underwriter

Your underwriter is another person that you'll probably never talk to, but she is important in that her job is to make sure that your loan application conforms completely to the loan you're applying for.

This means that everything you put on your application regarding your income, employment, and assets must be verified by the underwriter. The underwriter puts her name on the line, stating that your loan conforms and is approvable. If the loan ever goes bad, it's the underwriter who must explain what happened.

Mortgage loans are made in accordance with a set of previously established lending standards, be it a conventional Fannie Mae or Freddie Mac format or Federal Housing Administration, Veterans Administration (VA), or some other organization's lending rules.

When you apply for one of these loans, everything has to be in conformance with the rules. If the rules say that your total house payment must be no more than 33 percent of your gross monthly income, the underwriter will literally make those calculations on his own, confirming that indeed your income is in line with the loan rules.

If the loan requires you to have $10,000 in the bank somewhere, the underwriter will ask to see bank statements reflecting $10,000. A common underwriting requirement for real estate investors is that they have been landlords or otherwise self-employed for at least two years in order to qualify for certain loan programs.

In this case, the underwriter will look for a Schedule E from your tax returns or a letter from an accountant who has prepared your tax returns in the past declaring that you have been self-employed for two years or that you have owned investment properties for the past year or whatever the loan requires.

The underwriter can seem picky at times because she asks a lot of questions, but really she is simply making sure that your loan is in compliance with the lending guidelines.

The underwriter is the person who will give the thumbs up or thumbs down when reviewing questionable documentation.

There are loan requirements and there are loan guidelines. Guidelines means that there's some latitude. Requirements means that there's no variance from the lending script.

A good example of a loan requirement is that a self-employed borrower needs to have been in business for two years. I've had clients who have been in business for one year and ten months who simply had to wait. There was no variance in the rules: It was two years, period.

A guideline is something like a debt ratio. A debt ratio is the number arrived at when you divide monthly debt payments by gross monthly income. If your monthly debt payments are $5,000 and your gross monthly income is $15,000, then your ratio is $5,000/$15,000 or 0.33, or 33 percent.

If the ratio guideline is 33 percent and your ratio comes in at 37 percent, your loan may not automatically be declined. This isn't a requirement; it's a rule of thumb. If the underwriter feels that other parts of your application merit a guideline waiver, she can approve the loan with the higher 37 percent ratio, disregarding the 33 percent number.

Underwriters work directly for lenders; you do not pay them directly.

Inspector

A home inspector is an important piece of the equation in that the inspector goes over your property with a fine-toothed comb looking for structural defects or evidence of infestation with pests such as termites or other wood-eating insects (like my sister-in-law).

An inspector is different from an appraiser, who helps justify the market value. An inspector will look for things that are wrong with the property you're buying. While the paint job is nice and the roof looks okay, the inspector will crawl through the attic inspecting things that you'll probably never see or even know they're there.

An inspector will flip light switches to make sure they work, flush toilets, and even inspect sewage lines that run across your property line to make sure there are no leaks. If you're investing in an older home, an inspector will ascertain that the electrical and other utilities are up to code. An inspector will find things that neither you nor the appraiser can find and is an important party when you're buying property.

Your inspector should be an integral part of your real estate transaction, and if you establish a solid relationship with one, she can be an invaluable resource when you're determining whether or not a property is worth investing in from a structural standpoint.

An inspector should be an independent third party, not a general contractor who specializes in remodelings. An inspector should be someone who is trained to look for problems or potential problems, not someone who identifies those problems and also fixes them. That could lead to some self-serving actions.

Inspectors are trained to find problems and potential problems that the casual eye wouldn't catch. I recall a client who bought an investment condo in downtown Austin, Texas, and had just made an offer that was below the asking price but was almost immediately accepted.

Fast-accepted offers are not necessarily a sign of a problem with the property, and in this case it was simply a great deal in a hot market. But accepted it was.

She called me for financing and needed to rush, but I suggested that before we did anything further, such as ordering an appraisal, she should have the property inspected. She did so, and the inspector came up with a couple of things that she would never have noticed, but that revealed some issues.

The biggest problem the inspector found was that there was some water leakage from the master bathroom into the master bedroom. Even though there was carpet on the master bedroom floor, he suspected water damage.

How did he know? Certainly the carpet would hide any water leaks and was in fact doing such a good job of hiding them that even the seller wasn't aware of any water problems. But the inspector caught it.

At the bottom of the wall between the bathroom and the bedroom, he saw that there was a slight separation between the baseboards and the wall, about a foot long, while the rest of the baseboards were stuck solidly against the wall. It wasn't a huge separation, probably no more than an eighth of an inch or so.

The inspector looked a little more closely at the electrical outlet positioned right above the separation; he pulled out the socket and saw that the sheetrock was falling apart. He pulled up the carpet directly underneath the outlet and saw some obvious signs of mildew. He pulled up the carpet even further and saw that there was evidence of water leakage from the master shower through the wall and into the master bedroom.

This was a condo on the third floor, so there was no way to know if water damage had affected the unit below the one my client was thinking of buying. She contacted the people who owned the condo right below hers.

There was no water damage on the lower unit's ceiling, but she was concerned about the structure of the floor in the master bedroom. Water-sogged wood supports can be a problem, and there was no way for her to know how long the water leakage had been occurring. The inspector said that even though the wood was now dry, there was no guarantee that it would not happen again, nor any indication of how long ago the last leakage had happened.

My client withdrew her offer, and rightfully so. But had she not had a competent inspector, she would never have known about the water problem, and perhaps would have faced a future legal issue with the people who lived below.

Inspections, unlike appraisals, are not a lending requirement. Lenders don't require that you get a physical inspection of the property; it's typically up to the buyer. But if there is any money better spent, given the peace of mind that an inspection offers, I don't know about it.

How do you find a good inspector? I'd start with the ones your Realtor recommends. People who solicit Realtors' business know that they'd better do a good job or that Realtor won't refer them any more.

Perhaps more important is the experience your inspector has. Certainly you need to find out how many years your inspector has been inspecting, but there are also two other organizations that you need to be aware of: NACHI and ASHI.

NACHI is the National Association of Certified Home Inspectors, and ASHI is the American Society of Home Inspectors. While there are local and state licensing requirements, these two destinations require the inspector to have a higher level of experience as well as requiring him to attend certification and continuing education classes to keep his skills sharp.

When considering potential inspectors, either of these two certifications should be a requirement.

While physical inspectors for structural issues may not be a lending requirement, some states do require an inspection for pests, namely termites.

There's not a lot to elaborate about a termite inspection other than if the inspector sees evidence of any termite damage, old or new, then the lender will in fact require a complete inspection to show that there are no termites in the structure.

In fact, even in states where a termite inspection is not required, many people still order one. And it's a good call in areas where termites live. But when a lender sees a termite report that says, "Evidence of infestation: Yes," then the loan process slows down a bit until the termite issue is resolved.

Inspections generally cost approximately $400; this amount is typically not negotiable and is paid at the time of service.

Necessary Players

Attorney

Depending upon where you live or where the property that you want to buy is located, you might be surprised that an attorney is not a critical or important piece of the puzzle.

But an attorney's function varies depending upon the state in which the property is located. In California, attorneys are not involved in any way, unless someone wants to have his contract reviewed for his personal benefit. However, real estate contracts are normally dictated by the state agency governing real estate, so most of the legalese has been gone over so many times that a legal review is usually not needed.

In Illinois, however, attorneys are required; they handle the contract review for the buyers and sellers and hold the real estate closings. In Texas, attorneys have a limited, yet required role, as their legal blessing is needed on every set of home loan documents printed in the state of Texas.

Attorneys are an important piece of the transaction, and they're necessary where they're required. You probably won't have a bevy of real estate attorneys in your Rolodex, so you'll probably get your lawyer contacts from your Realtor.

I can hear a litany of lawyers reading this section screaming at me and telling me how important they are, and yes, when they're important, they're important, even if they're not required. And yes, there are also clients' interests involved, especially when issues such as limited partnerships, trusts, corporations, or other nonindividual entities investing in real estate come up. But overall, lawyers are needed when they're required and that's all.

Attorney's fees vary by region and customary charges and often can't be negotiated; a common range is $200 to $500.

Title Insurance Agent

Title insurance is a requirement on every loan that involves a lender. Title insurance is an insurance policy that protects the owners and lenders from previous claims to the property. Title insurance can be provided by a title agent or sometimes by an attorney, again depending upon where the property you're buying is located.

But they all provide one thing: title insurance.

Specifically, what is title and why should you care about it?

Title is evidence of ownership or an interest in property. If someone is "on title," then that person has a legal interest in the property, meaning that she probably owns some part of it or otherwise must be compensated when the property changes hands.

Lenders make loans on property only when they're presented with a title that's "clear." A clear title means that when the property changes hands from the seller to the new buyer, there are no other parties who could make a claim to the property.

For instance, suppose you buy a duplex in New Orleans, close on the deal, and begin to live happily ever after, collecting rent that more than pays for your mortgage. One day you open your mailbox, and there's a letter from a lawyer telling you that she represents a long-lost heir to the duplex you just bought and that you owe that heir money.

Not only that, but you may not even legally own the property.

Title insurance pays for such occurrences. A title insurance agent will research all previous owners and claimants, also making sure that there are no other liens on the property from home remodelers who never got paid or from back property taxes that remain delinquent.

If there is a previous claim on the property, you might be in trouble. But title insurance insures against such claims. That's why lenders not only like title insurance but also require that their interest (the collateral) be protected from any unknown "Uncle Harry" who feels that 15 years ago, he was cheated out of the duplex you purchased.

Assuming that Uncle Harry was right and he did have a claim, title insurance would pay off Uncle Harry, and you'd still own the duplex.

Let's assume for a second that you bought a property outright with cash and no financing. You'd still want to buy a title insurance policy, not only to protect yourself during the time you own the property, but also to protect yourself when you sell the property to someone else down the road.

Title insurance agents get paid by their company and not by you, but title insurance, like any other insurance policy, can be paid by either the buyer or the seller.

Closer

Your closer is the person who is responsible for overseeing the legal transfer of property from the seller to the buyer, and who physically makes sure that all required legal and loan documents have been signed as they're supposed to be signed.

The closer can be an attorney, a title agent, an escrow officer, or anyone else who is legally authorized to monitor closing transactions.

Lenders not only send your closing papers to your closing, but also send a list of "lender's instructions" that tell the closer exactly what needs to be signed, and where and when, before money changes hands.

Lender's instructions could include such things as "sign this piece of paper," "make copies of a driver's license and a passport," or "send us a legible copy of the original sales contract." They really can include anything the lender requires, but it's the closer who makes sure that everything is done exactly as the lender requests.

When your closer does what he's supposed to do, he's given a code number, commonly called a "funding number," that unlocks the money the lender has deposited in the closer's vault.

It's important that your closer does everything that the lender requires. Otherwise you could have a loan that's not yet settled but is accruing interest, or you could possibly lose the investment altogether because the closing did not take place exactly how and when it was supposed to.

Closers charge what's customary in the region, but typically a closing costs a couple of hundred bucks. The fee is not usually negotiable, and the closer is often selected by the seller or the seller's listing agent.

Surveyor

A survey is a physical description or a map showing the exact location of your structure on the property. A survey will show the boundaries of your property, setbacks, and all permanent improvements. Permanent improvements are things such as fences, sidewalks, your house, a storage shed, or a pool.

A survey done as a map looks like any other map, but it is a legal representation of your property. A survey may also be in written format, where the legal property description is done by a method called *metes and bounds* and reads more like a geography lesson.

A description of your property would be something like, "4 miles east of XXX, 253.4 feet from SYZ . . ." Some states, such as California, don't use survey maps but instead use the metes and bounds description included in the title report.

A survey will also show any easements that run through your property. An easement is the legal right of a third party to access your property; they are typically limited to utility companies, telephone companies, and the cable guy. When the water meter reader needs to read your water meter and it's in your backyard, the water company has a legal right to walk into your backyard without permission to read your meter. An easement allows for that.

There could be a utility pole planted squarely on your property that belongs to the electric company. During an electrical outage, the electric company can walk across your property to fix it.

Don't worry about easements. They're necessary, and usually they're not an issue. However, you do need to look at a survey to see exactly where the easement is issued. An easement will have a definite location on your property (where the utility line runs or the cable is connected).

Often a problem arises when you want to build on your property, especially when it comes to fencing or other boundaries. Let's say you don't build a fence, but you would like to put up a row of evergreen trees as close to your property line as possible to help deflect wind in the winter and to keep your nosy neighbors from watching you do whatever you do.

You must make certain that those trees aren't on your neighbor's property.

Once you've assembled a team of experts working for you, the next step is to consider the financing options available.

CHAPTER 4

Loan Types for Investment Property

Just as there is a myriad of loan programs for a primary residence, so too there is an endless supply of loan choices available to the real estate investor. Investment property real estate loan types can include the following:

Six-month CD ARM

One-year Treasury ARM

3/1 hybrid

5/1 hybrid

7/1 hybrid

Interest only

30-year fixed

15-year fixed

And that's just for starters. Each individual loan program can also have several interest rates from which to choose, depending upon how low you want your rate to be and how many discount points you want to pay—or not pay.

Investment property loans also have additional down payment requirements as well as certain stipulations concerning the number of properties owned, levels of documentation required, and experience as a landlord.

Each and every loan officer, especially a mortgage broker, will receive loan program rate sheets each and every day, either from his company's loan pricing department or from wholesale lenders who work strictly with mortgage brokers.

We'll discuss loan pricing and interest-rate adjustments in greater detail later in the chapter, but all in all, mortgage lenders really aren't very different from one another. In fact, if it weren't for their marketing departments, they would be nearly identical, as each lender will usually have the same loan programs as its competitors do.

But lenders have to appear different to their loan officers and their customers by presenting as many loan possibilities as they can come up with. I recall that when I was working with a major bank, our mortgage department would issue rate sheets that were seven pages long with no less than eight different loan programs on each sheet. That's at least 56 different loan programs. Now add the rate variables with each loan, usually about eight different rate and point combinations, and the result was nearly five hundred loan program and rate possibilities.

That's ridiculous, in my opinion, but it's common nonetheless. In an attempt to appear different, a lender will offer variations on a single loan product to make it appear that it has something that another lender does not have.

Rarely, if ever, will this in fact be the case. Lenders base their loan programs on the very same indexes. Thus, 30-year fixed-rate loans from Lender A and Lender B are based on the same number. A one-year Treasury ARM will be based on the one-year Treasury. There aren't several versions of that; there's only one one-year Treasury.

Lenders can also take a particular loan program and give it a special name, again trying to appear different. For example, instead of being called a 40-year fixed, a loan that is amortized over 40 years could be called a "payment stretcher," or a loan that is amortized over 15 years could be called an "interest saver" or some such moniker instead of a 15-year fixed. Just understand that lenders simply don't have any corner on the loan program market.

Therefore there really are only two types of loans, not five hundred. Those types are fixed-rate and adjustable-rate.

Fixed-Rate Mortgages

Fixed-rate loans have one interest rate over the entire life of the loan and can be paid off, or amortized, over almost any predetermined period. Most fixed-rate mortgages are for 30 years, but these mortgages can also be packaged in 5-year increments from 10 to 50 years. A mortgage company may be quoting you only 30-year and 15-year increments, but it can certainly offer you anything in between as long as it's in a 5-year increment. But you may have to ask for them.

Fixed-rate loans are designed for long-term holding or to capture the bottom of interest-rate swings. Fixed-rate loans are good investment tools because you will never have to wonder what your payment will be 5, 10, or 20 years down the road.

A fixed rate also helps stave off any future inflation effects on your payment. If your monthly payment today is $1,000 in today's dollars, it will always be $1,000, regardless of how the dollar is devalued in the future as a result of inflationary pressures. You're locking in low rates and keeping your payment exactly the same.

The longer the term of a fixed-rate mortgage, the lower the payment, but also the more interest you pay in total. Shorter terms have lower rates but also increase your monthly payment, affecting your cash flow.

A common rate variance between 10- and 40-year loans looks like this:

Loan amount: $200,000

Term	Rate	Payment
10 years	5.75%	$2,195
15 years	5.75%	$1,660
20 years	5.75%	$1,404
25 years	6.00%	$1,288
30 years	6.00%	$1,199
40 years	6.125%	$1,117

Notice that as the loan terms increase, the rate increases slightly, but because of the period the loan is repaid over, the monthly payment is lower.

To see how important the loan term is on a fixed-rate loan, let's now look at monthly cash flow based upon a $1,500 rental income. We'll leave out taxes and insurance in this equation just to show the effect of rate and term.

Term	Rate	Payment	Rent	Profit (Loss)
10 years	5.75%	$2,195	$1,500	($695)
15 years	5.75%	$1,660	$1,500	($160)
20 years	5.75%	$1,404	$1,500	$ 96
25 years	6.00%	$1,288	$1,500	$212
30 years	6.00%	$1,199	$1,500	$301
40 years	6.125%	$1,117	$1,500	$383

Let's now look at the interest paid over the life of each loan term.

Term	Rate	Payment	Total Interest Paid
10 years	5.75%	$2,195	$63,400
15 years	5.75%	$1,660	$98,800
20 years	5.75%	$1,404	$136,960
25 years	6.00%	$1,288	$186,400
30 years	6.00%	$1,199	$231,640
40 years	6.125%	$1,117	$336,160

There is a definitive trade-off between term and payment. You want cash flow on your properties, so you need to have your rent exceed your own mortgage payment. But you also don't want to extend the loan term so far to increase cash flow that you'll hardly make a dent in your principal balance, at least until the latter years of the fixed-rate loan.

This is because at the beginning of each fixed-rate loan, most of the payment goes toward interest, with the remainder going to the principal of the loan.

In all likelihood, you won't keep a property 20, 30, or 40 years. You might, but it's not likely. Longer amortization periods keep your original loan balance intact, and when you sell the property, you won't have the advantage of a fully amortizing loan that has gradually paid itself down. A 40-year or even a 50-year note is available, but I don't suggest using one of these unless you really, really have to keep that payment down. And if that's the case, there are other options that can accomplish the same thing while avoiding long-term interest.

Using that same example, let's look at what the loan balance would be halfway through those loan terms:

Term	Rate	Payment	Midpoint Balance
10 years	5.75%	$2,195	$114,243
15 years	5.75%	$1,660	$121,453
20 years	5.75%	$1,404	$127,919
25 years	6.00%	$1,288	$135,700
30 years	6.00%	$1,199	$139,083
40 years	6.125%	$1,117	$154,479

The difference is staggering. With a 40-year loan, after 20 years you still owe $154,479; you have paid down the original balance by only $45,527. At the opposite end of the spectrum, after 5 years, a 10-year loan has been paid down by nearly half; you've paid off $85,757.

There is a balance; the combination of best rate and best term could be a 20- or 25-year fixed-rate loan, provided, of course, that you can still achieve positive cash flow on your unit.

Another consideration is whether or not to pay down the interest rate to make it go even lower.

Rates can be "bought down" by paying points, or discount points. A point is 1 percent of the loan amount and typically buys down an interest rate by 1/4 percent. Again, using the same example:

Loan amount: $200,000; 1 point = $2,000

Term	Rate	Payment	Rate	Payment	Savings
10 years	5.75%	$2,195	5.50%	$2,170	$25
15 years	5.75%	$1,660	5.50%	$1,634	$26
20 years	5.75%	$1,404	5.50%	$1,375	$28
25 years	6.00%	$1,288	5.75%	$1,258	$30
30 years	6.00%	$1,199	5.75%	$1,167	$32
40 years	6.125%	$1,117	5.875%	$1,083	$34

You can see the interest savings for each loan term, but you had to pay $2,000 in points. How do you determine whether or not to pay points?

You take the monthly savings with the lower payment and divide it into the cost of the point. The result is the number of months it will take to recover that point in terms of cash outlay.

Loan amount: $200,000; 1 point = $2,000

Term	Rate	Payment	Rate	Payment	Savings	Return (months)
10 years	5.75%	$2,195	5.50%	$2,170	$25	83
15 years	5.75%	$1,660	5.50%	$1,634	$26	76
20 years	5.75%	$1,404	5.50%	$1,375	$28	71
25 years	6.00%	$1,288	5.75%	$1,258	$30	66
30 years	6.00%	$1,199	5.75%	$1,167	$32	62
40 years	6.125%	$1,117	5.875%	$1,083	$34	58

Points are typically tax-deductible because they are a form of prepaid interest; you pay the lender interest up front in the form of a point and write it off just as you would mortgage interest.

I've never been a big fan of points; the return is just never that great, and I could do lots of things with that $2,000, like make improvements, invest it, or simply use it to pay down the loan balance.

What if you can't make any of the payments work? What if the market rent for the area is only $1,000 per month and the lowest you can get your monthly payment is $1,112? Then you need to reconsider the investment.

Are you buying in a depressed area where there are lots of rentals and few renters? Does the area have any long-term prospects of recovering, leading to increasing rents along the way? Do you anticipate significant near-term appreciation?

If any of these answers is "yes" or "probably," then you could take a small loss, but only if you can afford it and have certain reasons why you'd want a loss on a rental property. Your CPA needs to be consulted in such cases.

Adjustable-Rate Mortgages

Adjustable-rate mortgages, or ARMs, are so called because they can and do adjust, or change, at some point over the life of the loan. Fortunately, you know in advance both how and when the adjustment will be made.

An ARM has three components: an index, a margin, and caps.

The index is the starting point for figuring an ARM rate. An index can be any agreed-upon number, but common ARM indexes are:

One-year Treasury bill (Treasury Constant Maturity, or TCM)

Three-month Treasury bill

Six-month Treasury bill

Six-month LIBOR

One-year LIBOR

11th District Cost of Funds Index (COFI)

The next component of an ARM is the margin, or the amount in terms of percent added to the index. The final number, when the index and the margin are added, is called the *fully indexed rate*, which is what your monthly payment will be based upon.

For instance, you have an ARM based on a one-year Treasury bill and you get a notice in the mail from your lender telling you that your note can adjust in two months based upon the then-current one-year Treasury bill rate plus your margin. Common margins are 2.25 to 2.75 percent.

Two months later, the lender looks up the yield on the one-year Treasury bill, and it's 5.75 percent. Add your margin of 2.50 percent and your new rate will be 5.75 percent plus 2.50 percent, or 8.25 percent.

The final component of an ARM is the cap. An ARM will actually have two types of caps, an adjustment cap and a lifetime cap.

An adjustment cap is a consumer protection feature that limits how high your rate can go at any one adjustment. Common caps are 1 percent for every six months or 2 percent annually.

In the example listed earlier, if your initial rate was at 5.00 percent but the new fully indexed rate was 8.25 percent, that would be a significant payment change—so much so that it could create a payment shock sufficient to either suddenly make the investment unaffordable or reverse your cash flow to the negative.

On a $200,000 loan amortized over 30 years, a rate of 5.00 percent would yield a payment of $1,073, while the new rate of 8.25 percent would give you a payment of $1,502. That's $429, or an increase of nearly a third. That's hardly something you could adjust your rental income to compensate for, even if the markets were willing.

But because of the adjustment cap of 2 percent, while your true rate would be 8.25 percent, it wouldn't go more than 2.00 percent above the previous rate of 5.00 percent. It's capped. Now the new payment would be based upon 7.00 percent, or $1,330. That's an increase, but not as great a one.

Now, all things being equal, another year passes and it's time to adjust once again. If the index is still at 5.75 percent, you would add your margin of 2.50 percent and the fully indexed rate would again be 8.25 percent.

This time, however, your 2.00 percent cap won't protect you; your rate will go from 7.00 percent to 8.25 percent for the remaining year. One note: Just because an ARM can adjust doesn't mean that it will always adjust. It most likely will, but it doesn't have to. If year to year the index is 5.75 percent, then the fully indexed rate will always be at 8.25 percent.

The final cap component is the lifetime cap. The lifetime cap is the maximum the rate can ever go to throughout the life of the loan. A common lifetime cap is 6.00 percent. If you started at 5.00 percent, then your rate would never be above 5.00 percent plus 6.00 percent, or 11.00 percent. That's regardless of what your index does—even if your index hits 20.00 percent.

Your ARM will typically adjust with your index period. An ARM using the one-year Treasury bill will adjust once per year, while an ARM with a six-month index will adjust every six months.

Every ARM works the same way: Your index is identified, and the margin is added to find your new rate, taking caps into account.

When do you take an ARM and when do you take a fixed-rate product? In these two examples of fixed-rate mortgages and ARMs, the ARM rate was actually higher when it was fully indexed. This doesn't happen very often, but it can happen.

ARMs typically start out with a lower "teaser" rate. This teaser rate is an enticement to get you to take the ARM. A teaser rate could be 3.00 percent, for example; that's what your payment would be based upon for one full year on a one-year ARM.

For the same $200,000, the payment using 3.00 percent is $843.

That's significant, and that's why people select an ARM: to get the lower rate. Talk about significant cash flow.

In this instance, you would want to use an ARM if you were planning to hold the property short term, say for a year or two, or less. If you're going to buy a property to fix and flip, it's an ARM you want to look at first.

But let's say that you're looking at an investment property and you intend to keep it for several years—which is better for you, a fixed-rate loan or an ARM?

Essentially, take an ARM when rates are at relative highs and take fixed rates when rates are at relative lows. We'll discuss how rates are set in more detail in Chapter 5, but historically this is how you should look at loan types.

When rates are at relative highs, it's not the time to look at locking in long-term rates, since history shows that rates could soon move downward. And adjustable-rate mortgages can also move down just as they can move up.

By selecting an ARM when rates are in a high cycle, you'll both be locking in a lower "teaser" rate at the outset of the loan and potentially watching your index soften to a new low each year, with your monthly payment following it.

Then, as rates begin to bottom out, you can always refinance your mortgage into a fixed rate and lock in low rates for the future.

When rates are at relative lows, then forget about ARMs entirely and lock in the low rates.

There's no absolute forecasting of anything, other than death or taxes, I guess. This is especially true of interest rates and property values. However, using the past as a guide can help you predict the future.

One of the best resources I've found that tracks historical interest rates is an online site called www.hsh.com. This is the place to go to find rate patterns for almost every imaginable index, and I refer people to it frequently. This site has been documenting and reporting rate histories online longer than anyone else that I know of. You should bookmark the page.

Sometimes the fully indexed rate is higher than available fixed rates. This isn't a common scenario, but it happens; it is called *inversion*, where the yields on shorter-term holdings are higher than those on longer-term ones. This isn't normal in the marketplace. Typically a yield on a shorter-term investment will be lower than that on a longer-term one because the long-term investor wants to be paid more for tying his money up for so long. That's why six-month CDs pay more than three-month CDs.

When fully indexed ARMs are higher than the fixed-rate product, it's important to take a fixed rate, because, all things being equal, the ARM will eventually be higher than the fixed rate, and soon. That is, unless you're flipping quickly and you're certain that you'll have sold the property before an adjustment is made to your rate.

Interest-Only Loans

A feature available with both adjustable- and fixed-rate mortgage financing is called "interest only," or IO, loans. IO loans give the borrower the option of paying simple interest on the loan at any time, without paying anything toward the principal.

This can be a double-edged sword. While a 40-year fully amortized loan takes a long time to pay down the loan balance, an IO mortgage takes even longer—in fact, it would never pay the principal down.

The payment on an IO loan is calculated simply by multiplying the loan amount by the rate, then dividing the result by 12 to get a monthly payment.

The payment on a 30-year $200,000 loan that is fully amortized at 6.00 percent is $1,199. An IO payment at 6.00 percent on $200,000 is 6.00 percent × $200,000 ÷ 12, or $1,000 per month. An advantage with an IO loan is that if your property is currently vacant or otherwise not producing any income, then you can elect to make an interest-only payment to help offset the monthly loss.

Then, when you get another tenant or you begin receiving income again, you can revert back to the fully amortized payment of $1,199. An IO loan gives you some flexibility.

IO loans are not limited to fixed-rate loans; they can also be used for ARMs as well. If a fully indexed ARM rate is at 5.50 percent, then the fully amortized payment would be $1,135 on a $200,000 loan but only $916 with an IO.

One word of warning when considering an IO: Make sure you have some equity in the property going in or otherwise obtain additional equity through a sale, because an IO loan won't pay anything at all toward your loan balance unless you make extra payments yourself.

This is especially true with the temptation of zero-down loans. Buying investment property with zero down should be considered only by those holding for the long term. Why? Because of closing costs and associated costs to sell a property. We'll discuss costs in more detail in Chapter 6, but closing costs must be considered when selling and buying investment property.

For example, suppose you found a house that you wanted to buy at a bargain, hold for a few months while you do some touch-up work, then resell.

Purchase price	$ 200,000
Repairs/touch-up	$ 5,000
Acquisition costs	$ 5,000
Cost basis	**$ 210,000**

Acquisition costs are the closing costs involved when you bought the property. Standard closing fees on real estate investments will include appraisal charges, credit reports, lender fees, inspections, attorney fees, title insurance, and more.

You're now into this unit for $210,000. You'll need to sell it for that plus a bit more just to break even, right? Actually, no. Because when you sell, you'll also incur a new round of closing costs.

Unless you're a Realtor, you'll want to have a professional list and sell your property for you. Maybe you agree to pay your Realtor $8,000 as a listing commission.

You will also have attorney charges, some title and escrow fees, and a host of other closing costs associated with selling a home. Let's add another $3,000 of closing costs to the Realtor's fees and you're now at $11,000 to sell.

You now need to add the $11,000 to the $210,000 in order to break even. This doesn't count the miscellaneous hours you "donated" to the project that you didn't count as a hard cost.

Now you're at $221,000 to break even. But you're not investing in real estate to break even, are you? Goodness knows, you don't need the practice, right? A zero-down loan means that you don't have any equity to work with, and if you can't sell at the price you need to sell at, then it's possible that you'll be forced to either wait until you can get the price you need or bring money to the closing table.

Zero down means you must be certain of your future value; otherwise, you'll be paying closing fees out of your own pocket. A down payment would give you wiggle room. Zero down can mean writing a check when you sell a property. And an IO loan means that you've paid absolutely nothing toward the loan balance to help reduce your liability (that is, unless you paid extra on the loan while making an IO payment).

You can always make additional payments on almost any type of real estate financing. Rarely will you find a prepayment penalty, and when you do, it's either because you're buying a property with damaged credit and need a subprime loan (see Chapter 7) or because you elected to take a prepayment penalty to get a lower initial rate.

Prepayment penalties for those with excellent credit make an occasional entrance into the mortgage market, then escape for a few years, then come back. Why would someone ever take a prepayment penalty on a loan? To lower her payments.

Prepayment penalties come in two types: soft and hard.

A hard prepayment penalty means that if you pay so much as $1 additional toward the principal, then you may be subject to as much as six months' worth of mortgage interest as a penalty for paying ahead on your note. Hard penalties are mostly associated with subprime loans.

Soft penalties can sometimes be found as an option on mortgages for those with good credit. A soft penalty will let you pay additional principal on the mortgage, but no more than 20 percent of the principal balance during any successive 12-month period. Soft penalties usually expire after two or three years.

The rate with a penalty is sometimes as much as 1/4 percent lower than the current market rate. If you're looking at a term longer than two or three years on an investment property and a prepayment penalty is offered, then it's something you might consider.

A soft penalty still lets you pay extra (quite a bit extra, I might add), but it asks that you don't retire the whole mortgage with one big lump sum during the first 24 to 36 months. Most soft penalties also give you a reprieve if you sell the property, which would retire the note, instead of keeping the property and writing a check to the mortgage company to pay off the outstanding note.

Prepayment penalties aside, you can always pay extra toward a principal balance. But depending upon whether you have a fixed-rate loan or an ARM, the loan reacts differently when you pay extra.

With an ARM, you reduce the monthly payment, but with a fixed-rate loan, you reduce the term.

Using a 30-year fixed rate of 6.00 percent on a $200,000 loan, your loan would fully amortize in year 30. But if you paid extra each month on your mortgage, then your loan term would be shortened while your payment remained the same.

On the flip side, with an ARM, when you make an extra payment, your term remains the same, yet your monthly payment drops.

With a fixed-rate loan, there are certain patterns of prepaying, with the most common one being a biweekly program. With a biweekly program, you pay part of your mortgage every other week instead of once per month.

That means that you make 13 payments per year, or one extra payment per year.

On a 30-year loan, that typically knocks about 9 years off of your loan term, but what it really does is "piggy bank" your equity payments in your investment.

There are companies that specialize in setting up a biweekly system for you, for a fee; they usually auto-debit your account every other week and apply your extra payments and regular payment when they're due—on the first of each month.

But there's no reason to pay a fee when you can do this yourself. In fact, the easiest way to accomplish the very same thing is to take one month's payment, divide it by 12, and add that amount to each month's regular mortgage payment.

When you do that, you're making 13 payments per year and knocking 9 years off the term. And it's easier to do and less painful. After all, who wants to write a check every other week for a mortgage payment? Not me.

ARM loans accommodate extra payments by reducing the payment while keeping the loan the same. This is also called *recasting*.

When you make an extra payment on an ARM, when the adjustment period comes up, the new loan payment takes the new lower loan balance (that you paid down), then amortizes it over the remaining loan term.

If you originally had a $200,000 30-year ARM at 5.00 percent and you paid $10,000 extra in year one of your 30-year note, when your payment adjusted, it would recast at a reduced principal balance over 29 years, again at 5.00 percent should the index remain the same.

In this example, after the first year, the principal balance would naturally be $197,049 with a monthly payment of $1,069. But by paying $10,000 extra at or before the recast time one year later, the payment would drop to $1,014. However, you'd still have 29 years left.

Paying extra on a fixed-rate loan reduces the term. Paying extra on an ARM reduces the payment. This is important when considering loan types as well, just as it is important when reviewing loan rates compared to their history.

If you're aggressive in paying down your mortgage balances and rates are at relative highs, you'll get a boost with an ARM in the form of increased cash flow each month through both declining rates and recasts.

With fixed-rate loans and an aggressive paydown, you want rates to be at relative lows, and you need to understand that you're shortening the loan term by paying down the loan more quickly.

Hybrids

Another consideration is what you'll do when your well-laid-out plans just don't pan out. What if you bought a property that you intended to sell soon, but suddenly the market turned real south and you're stuck?

I mentioned that there are only two loan types, not 500. Okay, maybe there are two-and-a-half. The other one's a hybrid. A mortgage hybrid is a cross between a fixed-rate mortgage and an ARM. Okay, technically it's an ARM, but a hybrid performs like both a fixed- and an adjustable-rate mortgage.

A hybrid is fixed at the outset for a preset period of time. The most common hybrids are designated as 3/1 and 5/1 hybrids. A 3/1 hybrid is fixed for three years, then turns into an ARM, while a 5/1 is fixed for five years, then turns into an ARM.

Hybrids are a good choice because they start out with a lower rate than fixed-rate loans and keep that fixed rate longer than an annual or six-month ARM. It's sort of a best-of-both-worlds thing.

They're a neat gig, I think, and they have their place. Hybrids are really ARMs, and they have some features that can be dangerous, but if you're trying to decide between a fixed-rate mortgage and an ARM, and you're not certain, then a hybrid might be your best choice.

Since hybrids are in fact ARMs, they also have an index, a margin, and caps, and they use the exact same indexes, margins, and caps that regular ARMs do.

Hybrids normally offer initial rates about 1/2 percent lower than fixed-rate mortgages and about 1/2 percent higher than the teaser rate on ARMs. They're a nice fit for short-termers. If you're flipping, maybe a hybrid isn't for you, but it just might be if the future of real estate isn't set in stone—and really, when has it ever been?

What are the dangerous features of a hybrid? There's an additional cap called an initial cap.

An initial cap is the first adjustment that can be made after the initial fixed period. Many hybrids have a 5 percent initial cap rather than the 2 percent cap associated with a typical ARM.

That means that if you started at 4.00 percent on your 5/1 hybrid, but rates moved up considerably during that period, then you could be hit with a 9.00 percent rate after 60 months.

That aside, the hybrid does give the sense of security that comes from simply knowing what your rate will be over a specific period of time.

You won't be surprised at what your rate adjusts to because you'll be following the interest rates, watching to see if rates are moving up and you're in for a rate adjustment that you'd rather not have.

If this is the case—you see rates moving up and your adjustment is coming up—you can always avoid that adjustment by refinancing.

Refinancing

A refinance is nothing more than replacing a current loan with another one, and you can refinance for a variety of reasons.

Let's say your hybrid has been very nice to you over the past four years, but you also notice that your index has crept up to 6.00 percent and your margin is 2.75 percent. With your 5.00 percent initial cap, your rate will most likely go to 8.75 percent from your neat little 4.00 percent rate. Your payment will nearly double.

But because you were on your toes, you recognized this beforehand and applied with a mortgage company for a new loan. When rates are trending upward, almost all indexes will follow. This means that if ARMs are going up, then fixed rates usually are as well, unless there is rate inversion, which is unusual.

You have a choice to make: Do you want to refinance into another hybrid ARM? If so, your rate would be in between those on a fixed-rate mortgage and a one-year ARM—higher than the rate on the ARM, but lower than that on the fixed-rate mortgage.

When deciding which type of loan you want to refinance into, you should use the same logic as when you got the original loan. If you're holding long term, take a fixed-rate loan; for a shorter term, look at an ARM or a hybrid.

When you refinance out of an ARM or a hybrid that's about to adjust, you're avoiding that huge interest-rate adjustment that's coming up. Refinancing is simple; in fact, it's easier than the financing you got when you originally bought the property, primarily because there's no sales contract you have to perform to, such as closing by a certain date or making certain repairs.

Another reason to refinance is that rates have gone down, not up. In fact, this is the most common reason why people refinance: because rates have dropped below what they're currently paying and they want a better rate.

Refinancing because rates have dropped should be done only if you're planning to hold onto the property at least long enough to recover the closing costs that will be involved with any mortgage loan.

How low do rates have to go to make it profitable to refinance a mortgage? A common myth is that rates need to be 2 percent lower than the rate you currently have, but that 2 percent "rule" simply makes no sense.

Instead of targeting a specific rate, target your closing fees compared to the new payment.

It's important to remember that mortgage acquisition costs should be kept as low as possible, which means avoiding things like discount points or origination charges. Recall that paying $2,000 on a $200,000 loan lowers your interest rate by only 1/4 percent or so and that your payback period is around five years.

What if you paid a point on a hybrid or a fixed-rate loan and then refinanced three years after the original note? That means you've lost the benefit of the lower payment you bought at the beginning of the original mortgage. No one can accurately predict the future, but you can certainly have some contingency plans.

One of those contingency plans is to keep mortgage costs low so that you can more easily benefit from refinancing.

For example, suppose your current 30-year fixed rate is at 6.875 percent on a $200,000 note. Rates have dropped to 6.00 percent, and you're considering refinancing. First, compare your current monthly payment with the proposed new one. Here, 6.875 percent on $200,000 is $1,313 per month, while 6.00 percent on $200,000 is $1,199. You'll first notice that a change from 6.875 percent to 6.00 percent is nowhere near 2 percent, right? But you can also see that there is a difference of $113 in the monthly payment. That's like raising your rent, but you didn't have to.

Next, take a look at your closing fees. Say your closing costs for title insurance, appraisal, attorney, and everything else come to $3,000. Now divide that $113 into the $3,000 and you get 26. That's 26 months to recover your investment of $3,000 in closing costs.

You get an immediate benefit from the lower monthly payment, yet you have to consider that it cost you money to do so; in fact, it cost you $3,000. As long as you're keeping the property for 26 months, refinancing is probably a good idea. If rates drop only 1/4 percent, from 6.875 percent to 6.625 percent, the payment only goes to $1,280, or a savings of just $32. That's 93 months, which is far too long.

Another advantage with refinancing is that refinancing loans allow you to roll closing costs into your loan amount, something that you couldn't do when you bought the property. From a cash flow perspective, rolling closing costs into your loan keeps money in your pocket while reducing the monthly payment on the loan. It does add to your loan, so your payment will go up, but not by much. A $203,000 mortgage at 6.00 percent has a payment of $1,217, or an additional $18. Not a bad leverage, don't you think?

One main consideration when refinancing investment properties compared to refinancing a property you live in is that with a refinancing, you need some equity. Even if you acquired the investment with a zero-down mortgage, a refinancing typically requires at least 5 percent in equity, with most asking for 10 percent.

This is another good reason to be careful before buying with zero down.

That means that the maximum loan amount on the $200,000 duplex you bought must be 90 percent of $200,000, or $180,000. After a few years, it's likely that your property will have appreciated to the point where you have a 10 percent equity position.

Some investors buy what they think is a steal, hoping that it will be appraised for far more than what they paid for it. That can work, but it can work only after the first year. Lenders make mortgage loans based upon the lower of the sales price or appraised value.

If you bought some property and it was appraised at $200,000 but you paid $100,000, you don't automatically have $100,000 in equity—at least, not in terms of getting financing. The lender will base your loan on the $100,000 price, not the $200,000 appraised value. If you decide to refinance after 12 months, then if the appraisal still comes in at $200,000, you're fine.

This process is called *seasoning,* meaning that your value has been set in stone for 12 months. Seasoning applies to all properties, not just investment ones, but I emphasize it here because many investors buy with zero down hoping that the property will appreciate quickly.

Refinancing also provides an opportunity to pull equity out of the investment in the form of cash, called a *cash-out refinance*. While limits on cash-out refinances for investment properties typically stop at 75 percent of the value for conventional loans, if you have some equity that you'd like to pull out for whatever reason—for home improvements or to pay bills—you can borrow more than your current loan balance plus closing costs and get a check at closing.

For example, suppose that your property is appraised at $200,000, you owe $100,000, and you want to pull out $25,000 in cash.

Appraised value	$ 200,000
Current loan	$ 100,000
Closing costs	$ 3,000
Cash out	$ 25,000
Final loan amount	**$ 128,000**

If your initial rate was 6.875 percent, your payment on $100,000 would be $656, while the new lower 6.00 percent rate gives you a payment of $599, or a difference of $57. When you divide the $56 into the $3,000 closing costs, the result is 53 months, much longer than the previous example. But you reduced your monthly payment while at the same time accessing equity from the investment property.

This is another example of why you should pay little attention to how much rates have to drop in order to refinance and focus more on the actual numbers. Interest rates are factored into a loan amount, while closing costs are fixed.

If you refinance an $800,000 property and rates go from 6.875 percent to 6.00 percent, the payments change from $5,255 to $4,796, a savings of $458 per month. You'll recover your closing costs rather quickly at that rate.

The larger the loan amount, the sooner it will take to recover fixed closing costs.

Refinancing and pulling cash out should be done simultaneously, meaning that you shouldn't refinance a property just to get at some cash. It's an expensive proposition. Instead, consider pulling cash out of an investment property only if you were going to refinance the property anyway. There are cheaper ways to get at equity that don't have such high closing costs.

Equity Loans

An equity loan can be a line of credit or a single loan that is placed upon a property at little or no cost to you. If your property is appraised at $200,000 and your loan balance is $100,000, you could place an equity line of credit typically up to 80 percent of the value of the home, on the property at rates 1/4 to 1/2 percent higher than those on equity lines for a primary residence.

If there are any fees, there will typically be a government recording fee, but often a bank will waive all fees as long as you use the equity line at least once during a 12-month period.

When you refinance a mortgage loan, you'll have to qualify all over again. I know it might seem a bit redundant, but you are in fact getting a brand-new loan, perhaps from a new lender, and you'll be underwritten just as if it were a brand-new purchase.

This means that from a financial and/or credit perspective, things could have changed. If your credit has been hurt since you bought the property, you can anticipate a little more scrutiny. Or if your income has changed for the worse, then again you may find it more difficult to qualify for the new loan, whether or not you have made timely payments on the previous mortgage.

Or perhaps you've added to your investment portfolio and are now carrying additional mortgages or other debt, and so you might be facing some debt ratio concerns.

There are several sources for investment loans, but you need to understand the background of mortgages so that you'll understand how different loan programs view your financial status when reviewing your loan application to buy investment property.

Mortgage lenders make money by making loans. A mortgage company can have a bunch of money in the bank to lend out, or, more likely, it can have a credit line it can draw on as it places a new mortgage.

Say you just bought a rental house and borrowed $150,000. The lender will approve your loan, transfer the funds from its credit line to the seller's account at closing, and give you a mortgage to pay back.

If a lender has a $50 million credit line on which to draw, once that lender has issued around 300 more $150,000 loans, it will start to run out of money to lend. After all, with no more money, there are no more loans.

The lender can decide whether it wants to keep your loan and collect the monthly interest or to sell your loan to someone else, like another mortgage lender or Fannie Mae or Freddie Mac. Selling in this fashion is selling to the secondary market.

Smaller, independent mortgage lenders will almost always sell your loan before you ever make your first mortgage payment. That lender needs to free up its credit line, and quickly, in order to make more loans. Selling loans one by one is called *flow* selling, and it is so called because the lender uses it to keep its cash flow going.

Other banks and mortgage bankers will stockpile loans, then, when the balance has reached a certain point, sell an entire pool of loans to another investor; again another bank, a mortgage banker, or another secondary market player; this is called *bulk* selling.

But to do either type of sale, the loans must adhere to a strict set of guidelines.

Fannie Mae and Freddie Mac were both formed for the same purpose: to provide lenders with liquidity when they need it. Liquidity means more cash on hand that they can lend. Specifically Fannie Mae and Freddie Mac's purpose is to foster homeownership, but they do so by helping lenders make loans by providing them with more cash in exchange for the loans they have already made.

When you hear the term *conventional mortgage*, it means that the mortgage lender is responsible for issuing the mortgage loan and will take the heat if the loan goes bad. However, when a lender makes a conventional mortgage loan, it does so using secondary guidelines, or those set forth by Fannie Mae and Freddie Mac.

These guidelines are vast, but typical lending rules ask that the loan be at or below a certain dollar limit, that the borrower's debt ratios be in a certain range, and that the borrower verify his own funds to close on a home loan.

These underwriting criteria cover absolutely everything from what may or may not be on a title report to how many homes must be analyzed on an appraisal. In return for making loans that fit these lending rules, lenders can sell these loans to Fannie Mae or Freddie Mac or even to other lenders who might wish to buy loans and collect the interest instead of going out and finding brand-new ones.

The secondary market turns mortgage loan programs into a commodity; one 30-year fixed-rate loan is underwritten to the very same standards as another 30-year fixed-rate loan, and so the two loans are exactly alike.

And when there's a lot of one thing, there's tremendous price pressure to keep rates competitive. Lenders can get cutthroat when it comes to pricing a mortgage loan, and consumers don't have to wonder whether one loan is wildly different from another loan down the street—it's not, because it's underwritten using the very same set of rules.

Conventional loans, being the most common, are your best deal in terms of rate and fee structure. Conventional loans will have the lowest rates of any available loan product for investors.

That having been said, there are other guidelines that you must adhere to in order to qualify for investment properties.

- Number of properties owned
- Previous landlord experience
- Adherence to debt ratio guidelines

Number of Properties Owned

Fannie Mae and Freddie Mac have different guidelines when it comes to the number of properties you can own that have mortgages on them. Fannie Mae limits you to ten financed properties, whereas Freddie Mac limits you to four financed properties.

Note here that this doesn't mean that Fannie Mae won't make any more mortgages to you if you own 10 properties; you can own 20 or more, but the limitation is on the number of properties that currently have financing on them. Having 10 properties with loans on them means that you have to look outside conventional loans.

Fannie Mae is much more liberal than Freddie Mac with regard to the number of properties with mortgages on them that you can own. Conventional loans also ask for a minimum of 10 percent down for investment properties. Remember that neither Fannie Mae nor Freddie Mac actually approves the loan; the lender does. It's just that the lender approves the loan under Fannie Mae or Freddie Mac's guidelines.

Previous Landlord Experience

Another interesting twist in underwriting for conventional loans is that in order to use rental income from the unit(s) being purchased to qualify for the mortgage, the buyer must have two years of landlord experience.

This is important when you are buying multiple properties at once or in a short period of time. Sometimes an investor will buy several properties, but her current income levels can't support the new mortgage payments required on the investment properties.

In these instances, the rental income from the property to be acquired needs to be used to help qualify the purchase.

Adherence to Debt Ratios

For example, suppose an investor makes $8,000 per month. Typical lending guidelines ask that the borrower's debt ratio be around 40 percent, meaning that the total monthly debt divided by the gross monthly income should be close to 0.40, or 40 percent. But the investor sees a new property that has just been listed; it's a $200,000 duplex that brings in $3,000 per month in income.

The investor's current ratio is right at 40 percent; his total monthly obligations, including his primary residence plus his other properties, are $3,200 per month, and $3,200 divided by $8,000 is 0.40, or 40 percent.

The new mortgage payment on the $200,000 house with a 30-year, 6.50 percent rate plus taxes and insurance comes to:

Principal and interest	$ 1,264
Taxes	$ 165
Insurance	$ 80
Total PITI	**$ 1,509**

Adding $1,509 to the current debt load of $3,200 makes the new total debt load $4,709. With an income of $8,000, the ratio would be $4,709 divided by $8,000 or 0.59. While this is not a death knell, unless the borrower has some significant outstanding factors like credit scores in the high 700 or low 800 range or a lot of money in the bank, this loan might not be approved.

This transaction needs the $3,000 per month income in order to fit the 40 debt ratio guideline. Adding the $3,000 makes the ratio $4,709 divided by $11,000 = 0.42, which is much closer to the target and probably approvable.

If this is the investor's first purchase, however, and he has no landlord experience, he can't use the $3,000 to help him qualify. If this is not his first investment purchase and he has had two years of landlord experience, then the future rental income could in fact be used and the deal could close.

How does a lender know whether or not you've got experience at owning investment properties? It will simply ask for two years' previous tax returns and look on Schedule E of those returns to see if there are any entries for rental income.

Qualifying for conventional financing is sometimes more difficult than qualifying for other loan types in the market, but it should be your first source because of the lower rates.

Calculating Rental Income

Another underwriting quirk in investment property lending rules is how rental income is calculated for purposes of qualifying.

A lender can take the income information right off of tax returns, or the lender can simply take the gross monthly rent, multiply it by 0.75, and use the lower amount. Why would a lender reduce your monthly rent for qualification purposes?

There are two reasons: One, the property may not always be rented out, so there will be a vacancy factor, and two, the property will also need maintenance and repairs, and these will have to be deducted from your gross proceeds.

For instance, suppose your mortgage payment on a rental is $1,100, including taxes and insurance, and your rent is $1,300, so the income from the rental that a lender will use is 75 percent of $1,300, or $975.

Now, instead of showing a positive cash flow, you're actually being hit with negative rent. Subtract the mortgage payment of $1,100 from the adjusted $975 and the result is ($125). Not only will the lender not give you any income for that rental property, but it will add the $125 to your monthly debt load, much as it would do if you had an automobile loan or credit card payment.

Alternative Lending

What happens if:

You own more than 10 properties with mortgages on them?

You don't want to put any money down?

You need to use rental income to qualify, but you don't have the required experience?

You go outside of conventional lending to another, increasingly common loan type called *alternative* lending.

Alternative, or "alt," lending is an increasingly large pool of loans offered by various lenders and mortgage brokers all across the country that make loans that do not fit the current Fannie Mae or Freddie Mac guidelines.

Alt loans are made in a similar fashion to any other loan: You apply at a mortgage banker or broker, document the file, get approved, and move on. Alt loans are also sold to investors on the secondary market to increase liquidity, just like their conventional cousins.

However, alt loans reach outside the conventional box and offer a whole new array of lending guidelines that do not conform to Fannie Mae or Freddie Mac's. The catch, of course, is slightly higher rates. Not a lot, but some.

Alt loans also place more emphasis on adjustable-rate mortgages, and although alt loans do come in fixed-rate varieties, the differences between a fixed-rate alt and a fixed-rate conventional loan can be considerable, so most people who choose alt financing take a hybrid.

For instance, a common alt versus conventional comparison would look like this with 20 percent down:

	Fixed 30	**Fixed 15**	**5/1 hybrid**
Conventional	5.875%	5.50%	5.75%
Alt	6.375%	6.00%	6.125%

That's nothing to sneeze at; still, alt lending isn't that far out of the mortgage picture, and odds are that you'll use an alt at some point when your requirements fall outside the lending guidelines for conventional loans.

Alt loans have a base rate and then make adjustments to that rate depending upon various parameters, such as loan size or credit score or the degree of documentation. We'll discuss documentation in more detail in the next chapter.

For example, an alt product for a 5/6 hybrid might start out at 6.00 percent; the lender will then make adjustments according to its pricing matrix.

Table 4-1 shows a standard alt matrix for mortgage loans:

See the adjustments? It's extraordinary. There are 256 potential adjustments to one loan program. For instance, in this chart, if you wanted an investor loan of $650,000, you were prepared to provide all your documentation, including tax returns, your credit score was 668, and it was an interest-only loan, you would add a total of 2.625 points to the base rate.

Since 1 point usually equals 1/4 percent in rate, 2.625 points would increase your rate by about 5/8 percent, from 6.00 to 6.625 percent. Or you would simply pay the 2.625 points (which if you followed my advice, you wouldn't do).

Alt loans are not necessarily designed for people with bad credit. However, there is another group of loans called "alt A–," which stands for alternative A minus, that indicates a lower credit grade than a standard alt or alt A loan.

Not all alt lenders offer alt A– programs, but most do. Just don't confuse an alt loan with something designed for people who have harmed their credit.

Financing the Multifamily Property

Loans on multifamily properties are different from both conventional and alt loans. A property is considered to be multifamily if it has more than four units. While conventional loans can be used to finance up to a fourplex, when you go beyond that, the property falls into a new category. A multifamily property is most often an apartment building.

A multifamily property is considered a commercial property; hence, it requires commercial financing. Commercial financing is much different from conventional or alt financing and is based as much on the cash flow of the property as it is on the creditworthiness and equity position of the borrower.

Commercial financing also has higher rates, is often shorter term if

Table 4-1. An Alt Matrix for Mortgage Loans

	N Series Alt A Adjustments to Price for FIXED and ARMS							
	<=60%	60.01 to 70%	70.01 to 75%	75.01 to 80%	80.01 to 85%	85.01 to 90%	90.01 to 95%	95.01 to 100%
Loan Amt: $40,000–$49,999	2.000	2.000	2.000	2.000	2.000	2.000	2.000	2.000
Loan Amt: $50,000–$99,999	0.750	0.750	0.750	0.750	0.750	0.750	0.750	0.750
Loan Amt: $250,000–$417,000	−0.500	−0.500	−0.500	−0.375	−0.375	−0.375	−0.000	−0.000
Loan Amt: $417,001–$650,000	0.000	0.125	0.250	0.250	0.250	0.250	0.500	0.500
Loan Amt: $650,001–$1,000,000	0.250	0.375	0.500	0.750	n/a	n/a	n/a	n/a
Loam Amt: $1,000,001–$1,500,000	0.750	1.000	1.125	n/a	n/a	n/a	n/a	n/a
Loan Amt: $1,500,001–$2,000,000	1.000	1.250	n/a	n/a	n/a	n/a	n/a	n/a
Cash Out (not available in Tx on PR's)	0.000	0.250	0.375	0.625	0.750	1.000	1.250	n/a
2nd Home	0.250	0.500	0.625	0.750	1.000	1.250	1.250	n/a
Investor	0.500	0.750	1.000	1.250	1.500	1.625	n/a	n/a
2 units	0.000	0.000	0.125	0.250	0.375	0.375	0.500	n/a
3–4 units	0.250	0.500	0.625	0.875	0.875	1.000	1.125	n/a
Condo <=4 floors	0.000	0.250	0.375	0.500	0.500	0.500	0.500	0.750
Condo >4 floors	0.250	0.500	0.750	1.000	1.000	1.000	1.000	1.250
Non Warrantable Condo	1.000	1.000	1.125	1.250	1.375	1.500	n/a	n/a
Full Documentation	−0.250	−0.125	−0.125	−0.125	0.000	0.250	0.625	1.000
Stated Income / Verified Assets (SIVA)	−0.125	0.125	0.250	0.375	0.500	0.750	1.125	n/a
Stated Income / Stated Assets (SISA)	0.000	0.375	0.500	0.625	1.000	1.250	1.625	n/a
No Income / Verified Assets (NIVA)	0.000	0.250	0.500	0.750	0.875	1.125	1.625	n/a
No Income / No Assets (NINA)	0.000	0.375	1.000	1.500	1.750	1.750	2.000	n/a
No Doc (NINANE)	0.000	0.375	1.000	1.500	2.000	2.000	2.250	n/a
Fico >=720	−0.375	−0.250	−0.250	−0.250	−0.250	−0.250	−0.250	0.000
Fico 680–719	−0.125	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Fico 660–679	0.000	0.250	0.250	0.500	0.500	1.000	1.000	n/a
Fico 620–659	0.500	0.500	0.500	0.500	n/a	n/a	n/a	n/a
CLTV >95%	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250
DTI >50%	0.000	0.000	0.000	0.125	0.250	0.375	0.500	n/a
40 due in 30 (Fixed)	0.375	0.375	0.375	0.375	0.375	0.375	0.375	0.375
Interest only (Fixed)	0.375	0.375	0.375	0.375	0.375	0.375	0.375	0.375
Interest only (Arms)	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250
Ono Texas Property	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250
Escrow Waiver	0.250	0.250	0.250	0.250	n/a	n/a	n/a	n/a

you work directly with a commercial bank, and is most often tied to the prime rate plus a margin.

Lenders making multifamily, or apartment, loans look at a number called the DSCR, or debt service coverage ratio. That number also has a benchmark, and that benchmark is 1.2.

The DSCR is calculated by dividing the net income by the debt service. The debt service includes not just the loan payment, but also taxes, insurance, and other day-to-day expenses that the property requires in order to operate. A number below 1.0 means that the property is losing money. Anything above 1.0 means that the property is making money.

For instance, take an apartment building that has 12 units and generates $18,000 per month. Next, take the costs associated with operating those units, divide that into the income, and you get your DSCR.

Management expense	$ 1,000
Taxes	$ 3,000
Insurance	$ 1,500
Maintenance and repairs	$ 2,000
Utility payments	$ 3,000
Security	$ 1,000
Total expenses	**$ 11,500**
Net income	**$ 6,500**
Debt (mortgage)	**$ 3,500**
DSCR	**1.85**

In this example, the lender sees a positive cash flow; next, you need to qualify from a borrower standpoint, which means providing tax returns, assets, and credit reports.

When you invest in residential real estate, the lender values the property but doesn't concern itself with the income unless the income is needed to help you qualify. With a commercial loan, both you and the property must meet certain lending guidelines.

Commercial rates are higher, but then again, commercial properties shouldn't be compared to residential properties because they really are two different types of real estate.

A fixed rate for an apartment building might be 10 percent or more, compared to a fixed rate in the 6.00 percent range for residential real estate. Most often, though, multifamily investors elect to go with a shorter-term loan program, such as a hybrid, that offers lower rates, then refinance later on down the road when the loan begins to adjust.

Most short-term financing will come from a retail bank, although there are mortgage brokers who can also broker commercial loans. In fact, your mortgage broker has access to a niche area of commercial lending: commercial loans that fall between $100,000 and $1.5 million.

Many commercial lenders won't touch anything "that small." I know that sounds a bit odd—$1.5 million being labeled as "small"—but commercial loans are typically much larger than that.

Loans that fall into that range are called "small commercial" and often resemble residential loans when it comes to loan approval.

In fact, many of these small commercial lenders don't require a DSCR at all, but instead review only your loan application and credit profile.

Commercial loans also always require a down payment. You will not find 100 percent commercial financing; in fact, most lenders require at least 20 percent down. Commercial loans are also more expensive in terms of acquisition cost.

Appraisals can cost $1,500 or more compared with about $350 for a residential appraisal. Points and origination charges are almost always charged; in fact, I don't recall seeing a commercial loan without points. There is no such thing as a "no-closing-cost" multifamily loan.

All that having been said, however, multifamily investments can provide some serious cash flow, so if you're ready to play the commercial game, find a good management company to help run the complex, get the loan, and start making money.

Changing Investment Strategies

What if you bought a property intending to flip it, but you find that you can't sell it for a variety of reasons, and you decide or are forced to hold? If you took a short-term note and are left holding the bag long term, then you may be affected by the type of loan you took out.

For example, suppose you bought four duplexes in a town where a new factory had just announced it was moving in. This was a great deal, especially since the area had been so economically depressed that housing prices were at their low point.

But you also knew that you wouldn't be the only one to recognize this fact, and so you quickly snatched up some real estate before everyone else did. And you bought it close to where the new factory was going to be built.

You didn't intend to hold onto these properties, because you figured you could make a quick $40,000 selling them to other investors who were holders.

You acquired these properties using interest-only, short-term financing with zero closing costs. Fortunately, you put 10 percent down.

Why are you fortunate that you put 10 percent down?

Because six months later, the new factory deal fell through because the town the factory was moving to decided against providing relocation incentives to the new company.

Now you have four duplexes and four mortgages. But since you put 10 percent down, you also have some equity. Lenders need 10 percent equity in order to refinance a residential rental. And you will want to refinance into a fixed-rate loan before your adjustable-rate mortgage moves up at its next adjustment period.

This is key with investment financing: Have some equity going into the property, and keep your closing costs to a minimum. Pay no points, pay no origination charges, and, in most cases, pay little or no closing costs.

This strategy, explained in more detail in Chapter 6, gives you more flexibility should things happen to your best-laid plans.

Rent Loss Coverage

Your financing package may include a provision for rent loss coverage. Some loan types require such coverage and some do not; this can depend upon several variables for both conventional and alternative loans.

Credit scores, equity position, and number of properties owned can all contribute to the requirement for rent loss coverage.

Rent loss coverage is a form of insurance—issued as a supplement, or "rider," to your hazard insurance policy—that is designed to pay the mortgage should the property be damaged to the point where tenants can't live there, and therefore no one is paying you any rent.

Let's say the house was damaged by fire or the roof was damaged to such an extent that it had to be replaced or some other disaster occurred that made the property uninhabitable. While the property was being repaired, you wouldn't have to pay the mortgage payments out of your pocket; instead, the insurance policy would pay them for you.

Rent loss coverage does not pay the mortgage just because you can't find renters, a situation that is sometimes called a "casual" rent loss. It's a hard policy that pays the note during times of unit repair.

CHAPTER 5

Interest Rates and Rate Strategies

In a sentence: If rates are high, your profit will be low. You also need to know which type of loan to select for your properties based upon recent trends and forecasts. Sometimes it might be better to hold off on a purchase because of interest-rate conditions. And you certainly need to know when it's profitable and when it's not profitable to refinance your properties.

That's easy enough, right? There's no science to that. But knowing when to buy based upon the cost of money can be just as important as the cost of acquiring the property itself. Knowing how rates are set, how they move, and how they're quoted by your loan officer can mean the difference between getting qualified and gaining positive cash flow and either being declined or losing money every month on your rental property.

When rates are at their relative highs, it may not be a good time to invest in real estate if the higher rates have a negative effect on your cash flow.

It's easier to first explain how mortgage rates are not set. Your mortgage rate is not established by the Federal Reserve. Nor is it set by the 10-year Treasury.

This may come as a surprise, but it's important that you understand this concept, because as you're deciding how to pay for a property, rates are moving while you're thinking. Really.

Rates are set by lenders each and every business day, typically right around 11:00 EST. Why at this time? That's when all the economic news for that day has been released and mortgage companies have had time to digest all the new data.

Mortgage rates are tied to specific indexes; for fixed-rate loans, for instance, the most common is the Fannie Mae mortgage bond. Mortgage bonds are a trading commodity just like any other financial instrument. Investors invest in mortgage bonds every day, and the demand for these bonds from those investors causes prices to rise and fall.

And when there is more demand for anything, that means that the price goes up, right? The very same thing happens with mortgage bonds, but with interesting results: As the price of a bond goes up, mortgage rates go down. Just as with any bond.

First, though, how does demand affect the price of a bond?

Bonds are fixed investments. They don't change in value. If you pay $75 for a $100 bond that matures in 10 years, then you're going to get a guaranteed return. It's not a real sexy return, 33 percent appreciation over 10 years, but it's still a solid return.

Now compare a bond with another common investment, a stock from a publicly traded company.

If you found a stock priced at $75 today, would you expect only $25 in profit in 10 years? Probably not. Stock prices are based more on the profitability of a particular company, and stocks do not have a guaranteed return the way a bond does.

So why do people invest in bonds? There is a guarantee in bonds where there is no guarantee in stocks. And both are traded every single second of the trading day between buyers and sellers on Wall Street.

In strong economic times, investors put their money in stocks, anticipating higher profits from the companies they invest in and pushing up the prices of those companies' stocks. In recessionary periods, companies can lose money, driving the price of their stock down.

If you bought stock in Widget Company for $25, and Widget Company suddenly sold a million widgets to a new customer, you could see that stock price go from $25 to $50. If you owned 10,000 shares of Widget stock, you just made $250,000—at least on paper (if you didn't cash in).

But suppose you find out the next week that the company that Widget sold all its stuff to had gone bankrupt and couldn't pay Widget its money. Widget is out of inventory and out of cash, and it has no more customers to sell widgets to.

The stock then drops from $50 per share to $1 per share. Since you owned 10,000 shares, last week you made $250,000, but this week you lost $490,000. Quite a week, wouldn't you say?

Bonds, however, do not have that volatility. Whatever price you bought your bond at, you're guaranteed a return. Bonds are boring, but they're predicable. Stocks can be exciting, but they're anything but predictable.

During economic boom times, when everyone is rosy on the economy, more money flows into the stock market and out of bond markets because of the likelihood of greater returns. Yes, making $25 over 10 years isn't a great return, but it's a heck of a lot better than losing $490,000.

And during times of economic weakness, investors take money out of stocks and put them in safer investments, like bonds—all sorts of bonds, including mortgage bonds.

As demand for bonds increases, the prices of bonds move up. As demand for bonds softens, their prices move down. But the yield on your original purchase price (profit) remains the same. This is the function of rate and yield. Stay with me here, because unless you understand these dynamics, you can find yourself bamboozled by a shifty loan officer who is quoting you higher rates when rates should be lower. And locking in a higher rate can cost you each and every month.

Understanding these dynamics also means that when rates are moving up, you may want to wait to buy a property, or that you may select an ARM over a fixed-rate mortgage when rates are at relative highs.

If you don't understand how mortgage rates move, then you really shouldn't be investing your money in real estate. As with any other investment, if you don't understand the acquisition cost, you can't evaluate the true profit.

It works like this: Let's say a bond is priced at $100 and yields 6.00 percent a year over five years. After five years, your $100 is now worth $134. Sure, there might be some more exciting prospects than making $34 over five years, but bonds offer security and not excitement.

Mortgage bonds are also traded throughout the day, and lenders peg their daily interest rates to the exact same index and have some very smart people at their company who do nothing but watch the price of mortgage bonds all day, hoping to predict the future of mortgage rates at the same time.

How do the prices of mortgage bonds affect rates? Let's say there are suddenly signs of an economic slowdown. Unemployment reports are showing more and more people out of work, and the gross domestic product, or GDP, is slowing down or perhaps even showing negative growth.

When investors see these data, they may pull their money out of the stocks they had invested in so that they can keep their profits, but they don't want to just park that money in a cash account somewhere. They buy bonds while they weather out the economic storm.

Now, if more and more people want to buy the very same bond, it's going to drive the price of that bond up. The 6.00 percent return will remain the same, but the bond price moves up, to $101, for instance. It may even move higher if continued economic news is being released and more and more investors push up the price of mortgage bonds because of their safety.

If you pay $103 for that same bond, your return will be $31, not $34, as a result of the rise in price. Therefore, as the price of a mortgage bond increases, mortgage rates go down.

Conversely, signs of economic strength will hurt mortgage bond prices and drive rates up. Less demand means that sellers of bonds will reduce their price to attract buyers. Less demand and lower prices mean higher rates ahead.

But to be ahead of the game, you need to know what the Fed is or is not going to do at its next meeting. While no one really knows this until after the fact, watching economic indicators and key indexes can help you determine when to lock in an interest rate and when to stand pat. Some of the most significant economic reports that will affect your interest rate are:

• Employment	Higher employment = higher rates
• Factory orders	More factory orders = higher rates
• Hourly earnings	Higher wages = higher rates
• Gross domestic product	More factory output = higher rates
• Consumer confidence	Greater confidence = higher rates
• Nonfarm payrolls	More people on payroll = higher rates
• Durable goods orders	More goods ordered = higher rates

Of course, the opposite can happen; rates will be lower if employment is lower and not higher, if factory orders are down and not up, if earnings are lower and not higher, and so on.

Another bedeviler of the economy is inflation. If you're guaranteed $134 on a $100 investment, you'll want to compare the value of the estimated return in current dollars versus future dollars.

Inflation eats away at profits. If there's an annual inflation rate of 5.00 percent, then that $100 you thought you had after one year is now only worth $95. Yes, you got your $134 return after five years, but the dollar had devalued since you bought the original bond and the money just isn't what it used to be.

That's also a key concern that the Fed has: keeping inflation in control.

The way the Fed keeps (or tries to keep, anyway) inflation under control is by controlling a pivotal index, called the federal funds, or fed funds, rate. When the Fed holds its regular meetings, this is the number it adjusts; it doesn't adjust your mortgage rate.

The Fed adjusts the fed funds rate because that affects the cost of money at its most basic level—when banks borrow short-term money (as in overnight) to keep their reserves in line.

Throughout the day, a lender will not only make loans, but also cash checks or receive card payments. At the end of the day, however, the bank is required to have a certain amount of money in its vaults.

If a bank lends out all its money, so that when you go in to cash a check, it doesn't have any money, then there'd be quite a ruckus, don't you think? This is the purpose of reserves.

The fed funds rate hit an historic low in 2001, when the rate actually hit 1.00 percent. Think of that for a moment: an interest rate of 1.00 percent. That was a time when the economy wasn't doing all that well and the Fed wanted to help stimulate the economy by lowering the cost of money.

By lowering the cost of money to a bank, the Fed can encourage that bank to make more loans—cheap money, right? Conversely, when the economy is overheating or has the potential to overheat with low unemployment numbers, high wages, and a solid GDP, the Fed will begin to increase short-term rates to discourage banks from making loans.

Banks make loans to businesses so that they can hire more people or make more widgets, and the better business is, the more money companies might want to borrow.

There is a constant ebb and flow in the money markets, and this is something you need to understand so that you can catch mortgage rates at the most opportune time—or at least get as close as you can.

Economic Indicators

It's important that you understand what will worry the Fed one way or the other. Essentially, if anything shows positive growth for the economy, then the Fed will be looking at raising the fed funds rate. While it rises by only 1/4 to 1/2 percent at a time, this is still a significant increase in the cost of funds.

Economic reports are released throughout the business month and there are a number of them, but the ones that have the most impact on interest rates are:

Unemployment report

Consumer Price Index (CPI) and Producer Price Index (PPI)

Gross domestic product

Factory orders

Retail sales

Consumer confidence

Personal income and personal spending

Chicago Purchasing Managers' Index

Productivity

Unemployment Reports

This report is one of the most influential economic reports released. It is released the first business Friday of each month, and it shows three key elements:

The unemployment rate

Nonfarm payroll

Wages

The unemployment rate is stated as a percentage and is perhaps the most widely published number coming from this report. For instance, an unemployment rate of 5.565 percent would mean that of all the available workers in the United States—those who are either working or actively looking for work—5.565 percent are currently out of work but are looking for work.

The nonfarm payroll number is the most important number of the three; it compares job growth from month to month in a numerical format. The nonfarm payroll number might show that 400,000 new jobs were created during the previous month.

Now, 400,000 new jobs is a significant number, indicating a growing economy with a bunch of new people with fat paychecks entering the labor force. This could mean that the Fed will increase the fed funds rate at its next meeting.

A meager job growth number (say, 50,000) or negative job growth, where the economy actually pares employees, would indicate a likelihood of a Fed decrease in interest rates.

The wage number also can indicate whether or not working employees are making more money than they did the previous month. More money in someone's pockets means that that person is likely to spend that money on something like a new big-screen TV or a new car. More demand for consumer products can drive up prices, meaning more inflation down the road.

In this example, the Fed would consider raising interest rates to cool off the economy.

Consumer Price Index and Producer Price Index

This is a month-to-month comparison of the prices people pay for goods from one month to the next. It is an initial indicator of possible inflation.

If more people are buying more products and businesses find that they can charge more, then the Fed will keep a keen eye on this number.

The Consumer Price Index, or CPI, measures the prices people pay at the retail level—at your grocery store or hardware store.

The Producer Price Index, or PPI, measures the wholesale prices at which businesses sell to one another.

There are a couple of volatile components in these indexes, with the two biggest being food prices and energy prices. Both can make wild swings from month to month, so they're often removed from the index.

If there's an oil pipeline shutdown somewhere and the price of a gallon of crude suddenly spikes, that doesn't necessarily indicate that the economy is growing as a result of demand for goods and services.

No, in this case the price of oil went up simply because of a one-time event. Food prices can behave similarly. A sudden cold snap could hit Florida or California, for instance, and wipe out much of the orange crop, reducing supply significantly and raising prices.

Neither of these one-time events is indicative of inflation caused by increased demand; the price rise is due to external forces that have nothing to do with consumer interest. That's why this more volatile "food and energy" component is often removed from the CPI and PPI number for analysts to digest.

Gross Domestic Product

The GDP number is the total cost of goods and services produced in the United States. Everything. Shoes, gasoline, automobiles, airplanes—everything is added up and tallied. This report is issued quarterly.

The GDP number shouldn't have very many surprises in it, since many of the data are tallied monthly. However, there can be surprises, and when there are, the markets can get hit pretty hard one way or the other.

A surprising number would indicate that either significantly less goods were produced than anticipated or significantly more goods were produced than anticipated.

Factory Orders

This monthly number shows activity on a wholesale basis and logs purchase orders from the previous month by various businesses and service providers.

More factory orders indicate a strengthening economy, leaning toward higher rates.

Retail Sales

This is another month-to-month report that gathers all the sales data from all retail outlets in the United States. Retail sales include food, clothing, entertainment, plasma-screen television sets—everything that consumers can buy in the open market.

This report can also be affected by seasonal factors and is adjusted accordingly. For instance, retail sales in December are always stronger than retail sales in July because people buy lots of presents in December.

Retail sales are also compared on a yearly basis, with February of this year being compared to February of last year. There is also another retail sales figure called "same store sales" that looks at retailers, such as Home Depot, and compares retail sales numbers for the current month to those from one year ago for all stores that were open during both periods.

Higher retail sales indicate a growing economy, and, of course, slower sales mean a slowing economy.

Consumer Confidence

This report also has a significant effect on interest rates. Confident consumers buy more things and put more things on credit cards, as they have a mindset that everything is coming up roses and they will be able to pay the bills.

Consumer confidence also affects other reports, such as retail sales, home sales, and almost anything involving the retail sector.

When consumers lose confidence in the economy, the economy begins to shrink, carrying with it the likelihood of lower rates in the future.

Personal Income and Personal Spending

Personal income is tracked to anticipate higher retail spending. The more money people have, the more they'll spend. Personal income growth is also a measure of inflation. If people make more money, that's because their employers are forced to pay them more as a result of a tight job market.

The employers must then pass that additional labor cost through to the price of their goods and services, affecting inflation.

Both personal income and personal spending increases can cause interest rates to rise and produce a double-whammy of inflation and economic growth.

Chicago Purchasing Managers' Index

The Chicago Purchasing Managers' Index (PMI) report is a nationwide tally of business and factory purchasing agents, asking them how much stuff they bought in the previous month.

This could include widgets to make other widgets, automobile tires to put on new cars, or just about anything that a business buys to build things with.

When a company orders 100,000 new tires from a tire manufacturer, one can conclude that the automobile manufacturer is getting ready to produce a lot of new cars.

A strong PMI shows a strengthening economy, which can result in higher rates.

Productivity

Productivity is a measure of the output of consumer goods and services as it relates to how much is produced per capita. That means that people make more stuff or serve more people with the same or less effort than they used to.

Having more products or more services produced by the same group of producers available on the market helps to keep costs down and is a key component in the rate mix.

These reports are released over the period of a month and then are repeated the following month. And sometimes there's a frenzy. One report may show strong economic growth, while a subsequent report can indicate a slowing economy.

For instance, retail sales could show a month-to-month decrease, yet 350,000 new jobs were added in the economy. Conflicting reports will make for a choppy market.

Still further, a report could indicate no change whatsoever. The trend could be sideways!

Do you need to spend sleepless nights wondering what the unemployment rate for the previous month will be? Of course not. But you do need to keep an ear to the ground regarding the economy in general, and if you notice that the economy is beginning to show some signs of weakness (over an extended period, such as three to four months), be prepared to refinance your properties to lower your rates or wait a month or two to buy another rental.

How Interest Rates Move and How They're Set

If you don't know how rates move and how they're set, you're missing out on a key component of your real estate investment strategy. Interest rates can change without warning, and if you miss an opportunity to lock in interest rates while they're at their bottom, you'll pay for that nonchalance each and every month as you make your mortgage payments and deposit your rent checks.

The Fed reacts slowly to all these economic reports. There will be no knee-jerk response from it with regard to adjusting rates. In fact, the Fed meets only every six weeks or so and rarely has an emergency session.

Thus, the real reason to follow these economic reports is to get an idea of what the Fed might do at future meetings. If there are continued signs of an economic slowdown, then mortgage bond traders, and other bond traders, will begin to increase their holdings of mortgage bonds.

That means that the prices of mortgage bonds will be higher, resulting in lower mortgage rates for consumers.

If the economic reports indicate a healthy, growing economy, then more money will be pulled out of bonds and put into the stock market, lowering bond prices and increasing mortgage rates.

That's why, when the Fed has a meeting and announces that it has adjusted the fed funds rate by $^1/_4$ percent one way or the other, you won't see wild interest-rate swings; in fact, there probably will be no rate swing at all because the Fed moves have been not only anticipated but also priced into the mortgage rate.

If you base your investment strategy on what the Fed does instead of what it might do, you're way behind the curve. You need to make your real estate investment decisions based upon the same anticipation that mortgage lenders have.

That's why by the time the Fed does anything about interest rates, there's little immediate effect on the mortgage market. Lenders are pretty good at anticipating Fed moves and have a bevy of people who do nothing but set interest rates.

Mortgage rates can change throughout the day as a result of the reaction to market data that are released. Rates can also change because of noneconomic and political factors, such as overseas turmoil, wars, or political unrest that might affect the growth of the U.S. economy.

Mortgage rates can change throughout the day, as mortgage companies follow the markets all day long and react to them if need be.

For instance, it's 11:00 a.m., and the nonfarm payroll numbers come in just as expected, so the mortgage bond markets don't react. Rates are stable for that day. So far.

Later that afternoon, a report is issued showing that the new home construction numbers are below expected levels, and a Fed governor somewhere announces that he sees reduced signs of inflation. A Fed governor can be at a luncheon somewhere, and everyone hangs on his every word to get a hint of what the Fed is thinking.

Two things have happened since the release of the rates for that morning: New home construction is down, indicating a possible slowdown in the economy, and the Fed sees no inflation problems down the road.

Or so lenders guess. In this instance, it is likely that a rate change would be in order for that day, so the lenders resend all their interest rates to their loan officers and mortgage brokers, who are excited that rates have gone down 1/8 percent since early morning.

The next day, existing home sales are released, showing strong sales in various parts of the country: Sales "exceeded analysts' expectations," and home prices are higher than what everyone thought they would be.

Guess what? Seeing signs of a pickup in the economy, lenders consider the state of the economy all over again, now thinking that the Fed may be considering a rate increase instead of a decrease at its next meeting.

So rates go up from the previous day.

I know this sounds a little hectic, but that's how it's done each and every day. It's also important to understand this when you compare one lender to the next, trying to find the very best interest rate.

Since lenders follow the same economic data and price their loans against the very same mortgage bond, that should also tell you that lenders' rates are essentially the same. One lender can't be at 6.00 percent while everyone else is at 7.00 percent. This can't happen, and now you know why. If someone is advertising a rate that seems too good to be true, it probably is.

That's also another good reason to shy away from unsolicited advertisements from lenders or loan officers that you've never heard of. One lender can't have some special rate that no one else has.

And it's also a good reason to use some of the referrals your friends or Realtors have given you. When companies that you've never heard of are asking for your business, what other way do they have to get your business than to offer some unbelievably low rate?

Instead, what you'll end up with is a bait-and-switch tactic: "Oh, that loan special was over last week, but let me tell you what I've got now, blah, blah, blah." This happens every day, so beware.

Your job is to secure the most competitive financing you can get, but if you can combine competitive loan pricing with competent service from your loan officer, well, that's the company you want to establish a relationship with.

But there's one important point to remember here: Lenders don't set interest rates; ultimately, the loan officer will.

I know that sounds incongruous with what I said earlier about lenders setting mortgage rates at 11:00 and so on, but what the lender does is set base interest rates for its loan officers to quote to its retail customers.

How Loan Officers Quote Rates to You

Most mortgage loan officers get paid on commission. So what a loan officer does each day is collect its lender's rate sheets from that morning and use them to quote you, the consumer, an interest rate that is competitive with the market and low enough to entice you to do business with that lender.

On a $200,000 mortgage loan, a lender might make 1 percent, or $2,000. The loan officer will get part of that, usually 50 percent, although megaproducers will command a much higher percentage of that profit because of their ability to find more loan business.

The rate sheet given to the loan officer looks something like this:

30-year fixed-rate loan

Rate	Points
5.00%	2.00
5.25%	1.00
5.50%	0.00

The lower the rate, the more points you'll have to pay. The higher the rate, the fewer points you'll pay, if you pay any at all. The choice of rate/point combination will ultimately be yours.

But what the loan officer is looking at is not your rates, it's his rates before he adds his commission on top of that and makes a quote to you. If the loan officer wants to make 1 point total on this loan, he'll quote something like this to you:

30-year fixed-rate loan

Rate	Points
5.00%	3.00
5.25%	2.00
5.50%	1.00

That's how it works. If the loan officer wants to try to make 2 points off of you, she'll add 2 points to the rate. Or if you don't want to pay any points at all, your rate will be increased accordingly, normally by 1/4 percent for each point the lender makes.

This is from a mortgage banker. A mortgage broker will get similar rate sheets, but he will get them from a multitude of wholesale lenders who are soliciting that mortgage broker's business. A mortgage broker might look at a dozen or more rate sheets every day, scouring them all for the absolute best deal.

But the secret is that since the mortgage lenders all base their prices on the same mortgage bond, the mortgage broker is looking for a variance in the price, not the rate. A mortgage broker might be able to find an interest rate that is 1/8 percent better, meaning about 1/2 point in discount.

That's an extreme example, as lenders usually aren't that far apart (although sometimes they can be). But if the broker can find a lender that offers that extra 1/2 point, odds are that he'll keep that 1/2 point in additional revenue on top of the 1 discount point he already plans to make.

We'll discuss in detail how to negotiate closing costs in Chapter 6.

With these two factors in mind, it's now important to understand both who sets the rates and where those rates come from. That means if you call one loan officer in the morning and call two others later that afternoon, you might find that the prices from the afternoon loan officers are a bit lower than the price you were given early in the morning.

It's quite possible that rates have moved during the day and that the rates in the afternoon were in fact a little lower. If you think that's the case, and perhaps even if you don't think that's the case, you should contact the morning loan officer and give her the opportunity to requote.

How do you know if there's been a price change during the course of the day? It's hard. Unless you subscribe to such data, it's difficult to get your finger on live mortgage bond pricing.

You might find mortgage bond prices listed in the *Wall Street Journal* the next day, but that's already old news and is of no use when you are wondering which rate and lender to choose.

There are mortgage bond reporting services that feed mortgage companies live data from the places where mortgage bonds are traded. This service isn't cheap for a lender or loan officer, and the price is so high that subscribing to it is not feasible for a consumer. Loan officers can pay $2,000 or more per year for such data. It wouldn't be worth it to you to pay that much.

Instead, try to track a couple of numbers that, while not specifically giving you interest-rate movements, can give you a general idea as to how the market is doing.

Macroeconomically, when the Dow Jones Industrial Average is doing well, it's likely that longer-term fixed-income securities like the 10-year Treasury aren't doing so well. Remember, when the economy looks rosy, people often pull money out of notes and bonds and move that money into stocks.

And vice versa. If the Dow is doing poorly and Treasuries are doing well, it's likely that mortgage bonds are performing favorably for you. That information is available almost anywhere on business news channels or the Internet.

Keeping Your Loan Officer in Check

You'll use this information to make sure that the loan officer who is quoting you rates is giving you the correct information as to why the rate you were quoted went down. Or up.

If your rate quote unexpectedly increases, you need to ask why. A competent loan officer will be able to answer this question, but the loan officer may say something like, "Well, the unemployment report came out and it was down/up."

You can certainly check that, but you can also check to see how the general markets are reacting. If the stock markets and bond markets are marching in tune in their respective directions, and this doesn't jibe with what you're being quoted, simply ask, "What is the Fannie Mae mortgage bond doing today?"

If you ask that question, you can be guaranteed that your quoting loan officer won't be playing any rate quote games with you. You have just shown him that you know how rates are set, so he shouldn't try to play such games with you.

This whole scenario, however, doesn't include everyone. Just because the economy overall isn't performing well doesn't mean that there aren't areas that are booming or that have lower-than-average real estate prices.

Interest Rates Are National

As an investor, if the national economy is soft and rates in your area are moving down right along with it, you need to remember that real estate is local, meaning that what's cooking in Queens may not be all that desirable in Detroit.

Interest rates are set using the very same index by lenders all across the country; there aren't different rates for Florida and for Wyoming, for instance—the rates are national. That means that if rates are low and your area is soft, you might want to be on the lookout for other parts of the country where real estate is selling because of local activity.

You can have a market that is experiencing it's own "mini-boom" while at the same time enjoying lower rates as a result of the national economy's being slow.

If you're a flipper, this is an ideal market for you, as you're able to invest at lower rates and still turn a profit later on down the road because the real estate market is hot.

The next piece of the rate puzzle is to guarantee, or "lock in," your rate quote.

Locking In Your Rate Quotes

Nothing is guaranteed. I can quote you an interest rate of 3.00 percent, but if I can't guarantee it, it's worthless, isn't it? Of course it is. That's why you need a lock agreement—to hold the lender's feet to the fire.

Interest rates can be guaranteed, but not forever. Most interest-rate quotes, for instance, are for a 15- to 30-day period. Longer lock periods are available, but it's not the lender who pays for the longer guarantee; it's you. For each additional 30-day period beyond the initial 30-day lock, you can expect to pay another 1/4 discount point.

If a 30-year fixed rate is available at 6.50 percent for 1 point, if you want to lock it in for 60 days instead of 30, it will be quoted to you at

6.50 percent plus 1.25 points. Or, since rates generally move 1/4 percent for each point paid or not paid, you can simply increase your rate to 6.75 percent, still pay only 1 point, yet have that rate guaranteed for 60 days and not 30.

Lenders will also typically be willing to lock you in for 90 days, but if you want a lock period longer than that, most lenders will ask that you pay them a 1 percent origination or commitment fee up front. Why?

When you lock a loan with a lender, the lender in turn locks your rate request in its pool of mortgage funds. The lender has reserved some money with your name on it at a particular interest rate. If you lock with a lender and your deal falls through for whatever reason, the lender will typically lose some money on the deal.

When lenders reserve money for you and the lender breaks the lock, it can cost the lender a small fee or lost interest from you, or both. Lenders charge commitment and origination fees up front to help keep consumers from locking in a rate when they are not yet committed to any particular lender. Lenders don't like to tie up their money unless they have a committed client.

Longer-term locks should be used only for construction properties to replace a construction loan, or for a property that's not yet finished but soon will be. When you shop for a rate, you may not have the luxury of comparing too many lenders all at once. When you find a property you want to buy, you'll typically have 30 days or so in which to close the deal. This means you don't have the time to get lenders to compete for your loan; you need to decide on a lender, make an application, and move on.

You'll want to have selected a lender a minimum of three weeks before you close your deal. Anything shorter than that and you can run the risk of not closing on time because you were still rate shopping.

Refinancing, on the other hand, gives you a little more leeway and strategy when it comes to interest rates. There is no time frame in which you must perform; you can apply at a lender somewhere, maybe open up a title report and pay for an appraisal, but you can wait, and wait, and wait until your magic rate arrives.

If you've already determined that refinancing a property is a good thing, as explained in Chapter 4, then, while you can wait around because you have that right, three things can happen:

Rates go down while you're waiting.

Rates go up while you're waiting.

Rates do nothing while you're waiting.

And each of these possibilities has its own risks.

Rates Go Down While You're Waiting

If you locked, this means that you locked at the wrong time. If you were smart and did not lock, but "floated" your loan rate, then you won. If you locked in with a lender, you can't call up the lender and ask for the new lower rates. The lender won't honor your request.

So you have a couple of choices: Do you swallow and take the rate you locked, knowing that rates have moved downward at other lenders (and also the one you're at because you locked), or do you try to negotiate or move to another lender?

First, if rates have moved down by 1/4 percent or more, you'll find you have a little more negotiating power. Lenders realize that if you move to another lender, you are taking a risk, as rates could move up again while you are doing so and it's possible that you could lose a sure thing.

If rates move by 1/8 percent or less, or only by 1/4 to 1/2 point, don't expect your locked lender to budge. If rates move more than that, threaten to move your loan to another lender. Lenders are well aware of rate moves and their consequences and will try to accommodate your relock request.

Remember, though, that when you lock in an interest rate, you should be relatively confident that it's a good move. You've already run the numbers and decided that current market rates are a good idea for you. Anything else on top of that is gravy.

If you lock and rates go down, you can threaten to pull your loan or you can accept the rate that you locked in, knowing that you got a good thing.

Rates Can Go Up While You're Waiting

This probably means you got greedy. You had already determined that the new lower rates would benefit you and your properties, but you wanted to squeeze out that last extra 1/8 percent because, well, all the economic reports pointed toward still lower rates.

The problem with that scenario is simply that things happen. No one knows where interest rates are headed; they can only make educated guesses. And people a lot smarter than you are watching rate moves like a hawk. At least, a lot of people who think they're smarter than you are watching. You are reading this book, after all. That's the risk of waiting. You had a good thing, didn't take it, and lost the opportunity. If you have several properties that can benefit from new, lower rates, you missed out big time.

If you're ever wondering whether or not it's a good time to lock, I always tell my clients this: Assume that whatever rate lock decision you make will have been the wrong one—which way would you rather be wrong?

Would you rather be wrong in locking in an acceptable rate now and enjoying the benefits for years to come, or would you rather be wrong in having an acceptable low rate but rates moved up on you while you were waiting—forever?

I thought so.

Rates Do Nothing While You're Waiting

Let's say that rates have moved to a point where you save $500 per month on your properties. You have five properties, and you will save $100 per month on each should you refinance. But instead of locking that in, you try to save another 1/8 percent, say from 6.00 percent to 5.875 percent on a $200,000 loan.

That's about $15 on each loan. You're already ahead by $500 by refinancing, but you wait one more month to see if rates drop further. They don't. So you wait one more and they still stay the same.

So far, by waiting, you've lost $1,000. You had $500 per month guaranteed, but you wanted a little more. You had significant gains in your pocket, yet greed got the best of you.

There are risks in all three scenarios, and you can harm yourself further simply by trying to make it just "this much more."

You can't be a serious real estate investor without keeping a keen eye on how the cost of your money is set. As rates move one way or the other, so should your investment strategy. Being able to anticipate rate swings instead of reacting to them will yield untold profits—not to mention helping you sleep a little better at night.

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CHAPTER 6

Investment Properties and Closing Costs

Investment properties carry the same typical closing costs as primary single-family homes do, but they also have some particulars that you need to be prepared for, as well as knowing how closing cost quotes work and how you can get through all the smoke and mirrors associated with interest-rate quotes and closing charges.

Interest rates and closing costs are the biggest shell game in the business.

Each time you finance a property, your loan officer is required to provide you with a Good Faith Estimate of Settlement Charges, or GFE, within three days after you send in your application or apply online, or immediately if you provide a loan application to a loan officer in person.

The GFE is a document that shows you all of the potential charges you might incur during that particular real estate transaction, whether that lender charges those fees or not.

For instance, even though the lender won't be acting as an attorney or performing any legal services for you, the loan officer is still required to give you an estimate, "in good faith," of what he thinks an attorney will charge for your transaction.

The same sort of cost estimate will be provided for other third parties as well, such as for title insurance or a rental survey.

Because real estate is local and is governed and licensed differently in different states, closing fees aren't universal. Standard closing costs for loans in Oklahoma will be different from those found in Florida, for example. That said, here is a list of expected closing costs:

Origination	1% of the loan amount
Point(s)	1% of the loan amount
Appraisal	$ 350
Rental survey	$ 100
Credit report	$ 15
Inspection	$ 200
Underwriting	$ 350
Processing	$ 400
Flood certificate	$ 65
Document prep	$ 100
Settlement/escrow	$ 200
Title search	$ 150
Loan documents	$ 250
Attorney	$ 250
Title insurance	$ 800
Notary fees	$ 25
Tax certificate	$ 40
Recording	$ 100
Survey	$ 400
Pest inspection	$ 100

Again, this is a rough list. Some people will notice that title insurance is very low—or very high. Or that there is no intangible tax or property transfer tax or some other fee. It's simply impossible and confusing to list all the fees that could pertain in all locales, but this is a good summary of the closing costs I've seen from California to Florida.

You also need to ask for the GFE when getting interest-rate quotes from different loan officers. When you get your rate quotes from Lenders A, B, and C, also ask for their Good Faith Estimates as well.

Here's where things can get interesting.

You will undoubtedly see three different rate and fee quotes from the three lenders. I know this sounds ridiculous, but it also points out how fractured the real estate finance business can actually be, with so many players having to provide their very own piece of information or service and mailing an invoice for that piece of information or service.

Loan officers who have been around for a while can rattle off these various fees in a matter of seconds, but other loan officers may use the Good Faith Estimate to try to make their rate quote appear better than their competitors'.

Let's say you want a 30-year rate quote on $200,000 that would be good for 30 days. You might get something like this:

Lender A	**Lender B**	**Lender C**
6.00%, 1 point	6.00%, 1.25 points	6.00%, 1 point

So far, it seems pretty easy, right? Lender B appears to have the worst offering, while Lenders A and C are tied.

However, you decide to query further and get a Good Faith Estimate from Lenders A and C, leaving Lender B out in the cold, since she was higher to begin with.

Lender A provides his estimate:

Appraisal	$ 350
Credit report	$ 15
Underwriting	$ 500
Processing	$ 400
Flood certificate	$ 65
Origination charge	$ 2,000
Total	**$ 3,330**

Lender C provides his estimate:

Appraisal	$	350
Credit report	$	15
Underwriting	$	800
Processing	$	600
Administrative	$	400
Flood certificate	$	65
Origination charge		2$ 0
Total	**$**	**2,230**

That's a difference of $1,100. Lender C wins, right? Well, maybe. You left Lender B out in the cold when you shouldn't have. When you called for rate quotes, you asked only for a rate quote; you didn't ask for a list of the lender fees that go with it.

If you went back and asked Lender B for her Good Faith Estimate, it would look like this:

Lender B

Appraisal	$	350
Credit report	$	15
Underwriting	$	100
Flood certificate	$	65
Origination charge	$	1,000
Total	**$**	**1,530**

Lender B now beats Lender A by $1,800 and Lender C by $700. Yes, the interest rate at Lender B is 1/8 percent higher, but the monthly payment at 6.00 percent is $1,199 and that at 6 1/8 percent is $1,215, only $16 higher.

If you divide that $16 difference into the $700 in closing costs savings, you'll get the number 43. That's 43 months that it would take to get the full advantage of the 6.00 percent rate and additional $700 in costs compared with $700 less in costs and a slightly higher payment.

Lender B has the better deal.

That's why interest-rate quotes need to be examined with a fine-toothed comb, even if you've got a seasoned veteran you're working with. Lenders can quote lower rates yet offset them with higher lender fees such as "underwriting" costs or "processing" fees.

Let's take it a step further. The previous example showed only lender fees; it didn't show title or attorney or anyone else's charges. So let's look at those now:

Lender C

Settlement or closing fee	$ 200
Title search	$ 200
Document fee	$ 250
Attorney fee	$ 175
Title insurance	$ 800
Recording fee	$ 100
Survey	$ 400
Total nonlender fees	**$ 2,125**
Lender C fees	**$ 2,230**
Total fee quote	**$ 4,355**

Lender B

Settlement or closing fee	$ 150
Title search	$ 200
Document fee	$ 250
Attorney fee	$ 250
Title insurance	$ 800
Recording fee	$ 85
Survey	$ 400
Total nonlender fees	**$ 2,135**
Total lender fees	**$ 1,530**
Total fee quote	**$ 3,665**

Lender A

Settlement or closing fee	$	50
Title search	$	50
Document fee	$	150
Attorney fee	$	50
Title insurance	$	399
Recording fee	$	50
Survey	$	100
Total nonlender fees	**$**	**849**
Total lender fees	**$**	**3,380**
Total fee quote	**$**	**4,229**

Suddenly, Lender A is slightly better than Lender C and, while still not better than Lender B, much closer.

Can you see the big problem here?

Lender A "low-balled" all third-party fees in order to make his quote look more attractive. The problem with this is: Lender A has absolutely no control over nonlender charges. He can quote pretty much anything he wants to because at the closing table, those fees will be what they're supposed to be and not what the misleading loan officer is quoting.

If you have different lenders' rate quotes along with their respective Good Faith Estimates, you should pay little, if any, attention to the nonlender fees. They will be what they will be, and if you see this kind of discrepancy, simply pick up the phone and call the attorney or the title company and ask it directly what it charges.

Types of Closing Costs

There are two groups of closing fees: recurring and nonrecurring and lender and nonlender.

We've just seen the differences between a lender and a nonlender fee quote. Recurring charges are charges that will occur again and again, such as your property taxes, hazard insurance, and mortgage interest, while nonrecurring charges are one-time charges associated with that particular transaction.

Low-balling of closing costs is not limited to nonrecurring fees. It can also be done with property taxes or hazard insurance.

Recurring charges can also be an issue when you are deciding whether or not to take an "escrow" or "impound" account, or the T and I in PITI. Most parts of the country call these escrow accounts, but in other parts of the country, the term *impound* is used to describe the very same type of account.

When you establish an escrow or impound account, you're paying one-twelfth of your annual tax or insurance bill each month. At the end of 12 months, you've accumulated enough to pay your property taxes and insurance when they are due.

This is convenient, and you never have to worry about whether your taxes or insurance has been paid. And escrow and impound accounts are an option only when you have a minimum of 20 percent equity in the deal.

If you put less than 20 percent down in the purchase, then escrow accounts are required; if you put down more than 20 percent, they are an option. Are escrow accounts a good thing?

Having escrow accounts will affect your monthly cash flow. If you collect $1,500 per month in rent and your principal and interest payment is $1,200, then you have cash flow of $300 per month.

If you escrow and add insurance and taxes to that—say, $50 per month in insurance and $150 per month for property taxes—you now have cash flow of only $100 per month, as PITI is now $1,400.

It's your call really. I'm of the opinion that it really doesn't matter whether you choose to have or not to have escrows, although others will disagree with me, claiming that you could put that monthly escrow amount into an interest-bearing something or other or into a reserve account for normal repairs and maintenance on the unit, and they'd be right.

It's just that the difference is so slight, since you will have to pay taxes and insurance on the property; it's just a matter of whether you do it every month and help ease the burden come tax time or you choose to sequester the funds somewhere else and let them earn some interest.

Refinancing and Escrow/Impound Account Strategy

There's one interesting feature about escrow accounts when it comes to refinancing.

When you refinance and replace your current mortgage with another mortgage, you'll also do the very same thing with the escrow account that you have with your current lender. Escrow accounts can't be transferred from one lender to the next; you have to pay for a new one, then wait to get your old escrow funds reimbursed.

This can require a sizable amount of money if you're refinancing toward the end of the year or just before your hazard insurance policy expires. This can be even more true if you're refinancing several properties at once.

Let's say your taxes of $150 per month and insurance of $50 per month have been put in your escrow account and it's close to the end of the tax year, yet your current lender hasn't paid taxes yet or renewed your policy.

After 10 months of insurance, that's $1,500 plus $500, or $2,000. You must come to the closing table with that amount of money, either in the form of a cashier's check or by rolling those escrow funds into your new loan. If you have five properties that you're refinancing, then that's $10,000 that you need to reconcile.

When you close on your units, your old lender will send you, in a separate check, the funds in your old escrow accounts, which add up to the amount you just provided for the new loans. This refund process doesn't take very long; normally you get your funds back within 30 days.

If you'd rather not tie up your cash for this long or add it to the principal balance of your new loan, you may decide to waive escrows on the new loans entirely. This way, you keep the $10,000 and still get the

$10,000 that you currently had in the old escrow accounts, and you pay the taxes and insurance directly.

Waiver Fees

One note: There is a fee called an *escrow waiver fee* or *impound account waiver fee* that is equal to 1/4 point of your loan amount. If you decide to waive escrows, be prepared to pay this charge. It can sometimes be negotiated away, usually at the discretion of the loan officer you're working with.

In reality, the escrow waiver fee doesn't disappear; the loan officer pays for it out of her own loan commission.

It's common to see people refinance investment property without escrow accounts toward the end of the year, then, after the first of the year, when taxes and insurance have been paid, contact the lender and sign up for escrow accounts. Lenders like people to have these accounts. It makes for less risk of defaulted payments on property taxes and insurance, so much so that lenders will hit you with that escrow waiver fee if you waive them.

In Chapter 3, we reviewed some of the players in the real estate transaction and discussed which ones had negotiable fees and which ones did not. The fact is that since closing costs and customs can vary from region to region, there is no one "standard" set of closing fees.

As a result, there are no strict lists of negotiable fees. In fact, even if a fee were negotiable, do you think the company would advertise it as such?

"Hi, we're ABC Appraisals, and our fee is $400, but of course we'll come down if you want us to." Think that'll happen? Nope. If it did, then ABC probably wouldn't be as profitable as it would like to be.

Government fees can't be negotiated, title fees and closing fees usually can't be, and inspection and survey costs usually can't be. But there's no reason not to call these folks up and ask, right?

If you're an active real estate investor who will need these services over and over again, then you can find some discounts if you promise to do business with that person or company exclusively.

The best way to keep tabs on closing costs is to keep copies of previous settlement statements from previous purchases area by area. Keep Texas settlement statements separate from Florida settlement statements. That way, if there's a fee that doesn't seem quite right, you can pull out the old settlement statement and compare the old one with the new one.

Title insurance is also a moving target. Some states do not allow title insurance discounts, and if they do allow them, all title companies must charge the very same fee. There are states in which title insurance discounts are available if you use them for a refinancing and if you used that title company for the last transaction on the same property.

Other states allow discounts on title insurance for refinancings regardless of which title insurance company you used. You need to both pick up the phone and call around and also use the experience of your loan officer.

Negotiating Closing Costs Through your Loan Officer

Ah, yes, the loan officer. The keeper of the keys—or at least the interest rates. There are a couple of ways to save money as a function of your mortgage.

Increase your interest rate to cover your closing costs.
Negotiate fees from your lender's loan officer.

Adjusting Rates to Cover Fees

In previous examples, you've seen how you can cover closing costs by increasing your interest rate by $^1/_4$ percent or whatever is needed. The amount needed can be found simply by dividing your closing costs (nonrecurring ones) by your loan amount.

The result is the number of points needed to offset those fees. Refinancing needs to be as close to closing-cost-free as possible. You don't want to add to the acquisition cost, since you'll want to sell your property in the future.

If your closing costs add up to $4,000 on a $200,000 loan, divide $4,000 by $200,000 and the result is 0.02, or 2 points. Increase your rate by 1/2 percent and compare.

Using a 6.00 percent, 30-year fixed-rate loan and 2 points, you get $1,199 per month and $4,000 in fees. At 6.50 percent, your payment goes to $1,264 per month, or up by $65, but you saved $4,000. You would not "recover" that $4,000 in fees until after the fifth year.

You need also to consider your cash flow when raising your rate to cover costs, but if it made sense to refinance at 6.00 percent, it probably also makes sense to refinance at 6.50 percent, and you're doing it for free.

There's another reason for obtaining a no-closing-cost loan both at the outset and during the course of ownership: Keeping your acquisition costs low lets you follow interest rates and refinance without any costs.

Note here that there's a difference between having no closing costs and rolling your closing costs into your loan amount. And really there's no such thing as a "no-closing-cost" loan, because there is in fact a cost that is associated with your new monthly payment. There are no costs, but there are higher payments.

Putting closing costs into your loan amount means that you have no out-of-pocket expense *and* that you got the lower rate. This increases your cash flow (by $65 per month, as we saw in the previous example), but examining the effect of rolling closing costs into your loan amount versus paying for them out of pocket looks like this:

Rate	**Payment**	**Comment**
6.50%	$1,264	No costs
6.00%	$1,199	$4,000 in out-of-pocket costs
6.00%	$1,223	Closing costs are rolled in with your principal

Suddenly the additional monthly cash flow from your investment property has shrunk to $41 from $65 because you rolled your closing costs in with your loan.

Let's also look at the result of financing those closing costs. You've borrowed them for 30 years by putting $4,000 into a 30-year loan. If you hold that loan to full term, that $4,000 really cost you an additional $4,633 in interest.

If neither one extreme nor the other is for you, or if you need as much positive cash flow as possible from a property, yet you still want to keep your costs low, then you can do a combination of a lower rate and reduced fees.

Instead of 6.50 percent and zero closing costs, perhaps 6.25 percent and $2,000 in fees works out better. Perhaps that's a best of both worlds scenario.

Every single lender and mortgage broker can offer a no-closing-cost loan; just remember that there's a big difference between a no-closing-cost loan and one that rolls the fees into your loan amount.

If you get a rate quote from a loan officer who tells you that she has a no-closing-cost loan but tries to sneak your closing costs into your loan, find another loan officer. Either she's not smart enough to know the difference or she's trying to cheat you.

Closing Costs for Flippers

No-closing-cost loan packages are also the choice for flippers, or for those who don't intend to keep the property for any real length of time, say a year or less.

When rates can adjust 1/4 percent to cover 1 percent toward closing fees, the lower rate with higher costs doesn't work for short-termers. Avoid every possible closing cost when you're investing short term; the advantages of the lower rate will never be realized.

For example:

$200,000 sales price

$4,000 closing costs

$20,000 remodeling/repair cost

6.00 percent rate

Anticipated sales price in 12 months: $ 260,000

The monthly payment in this scenario is $1,199.

$260,000 sales price	
Less loan payoff	$ 200,000
Less remodeling	$ 20,000
Less closing costs	$ 4,000
Profit	$ 36,000

Here's the same scenario, but with a rate of 6.50 percent and no closing costs:

$260,000 sales price	
Less loan payoff	$ 200,000
Less remodeling	$ 20,000
Profit	**$ 40,000**

Difference in monthly payment for 6.00 percent and 6.50 percent = $65 per month × 12 months = $781
Cost of lower rate with closing costs = $4,000 − $781 = $3,219

You lost $3,232 in profit by selecting a lower rate with costs instead of a higher rate without costs.

Negotiating Through Volume

If you're financing more than one property at a time, either because you're refinancing them or because you're buying them, you're in a better position to negotiate closing costs. That's even more true if the units are in one development or perhaps several condos in a condominium complex.

In both cases, you have properties that are in close proximity to one another, translating into an easy appraisal. One title company will pull title reports on the same subdivision, one attorney will handle all closings at the same setting, and so on.

With this scenario, you can expect to get the lowest of all possible closing fees from the various third-party providers. And let everyone know that you're comparing their costs with those of other competitors. This is especially feasible in a refinancing transaction.

With a purchase, often some of the third-party players have been chosen for you; perhaps the title company that is providing the title report is already in the sales contract or the seller has selected a closing company.

But with a refinancing transaction, you get to choose the people you want to work with; hence you get the opportunity to ask for a package deal.

Personally, I have offered discounts to buyers or owners who refinance or purchase multiple properties simultaneously. It saves me plenty of time. Instead of building five separate loan files, I simply compile one loan file, make copies of everything, and change the addresses where needed.

I also have made alliances with other third-party providers, such as title insurance companies and appraisers, to provide lower costs to my borrowers should the borrower select one of the companies I suggest.

Negotiating Fees with your Loan Officer

One final place to negotiate closing fees comes from your loan officer.

You'll notice that our previous example of closing costs listed lender charges such as underwriting or processing fees. In the Good Faith Estimate, these figures will be numbered, and lender fees (the ones you need to most be concerned with) are in the 800 series, with the appraisal listed as line item 803 and the credit report as line item 804.

It is in this section that you'll find lender "junk" fees—fees that you have a good shot at getting waived entirely.

The appraiser wants to get paid, so you won't get the appraiser to be nice enough to waive his charges, and the credit report folks want their money, of course, nice though they are.

Instead, you should be looking purely at the lender charges, those with odd names such as "processing" or "administrative" or "underwriting." Negotiate the best rate you can, then target these fees for waiver first, as the loan officer just might have some discretion over whether or not to charge certain fees.

Lenders charge junk fees, first, because they typically can in any given market, and second, because it helps them to offset the overhead associated with finding, processing, and (hopefully) closing a loan.

In reality, lenders could have long ago waived any fees whatsoever and simply charged higher rates, but they found that they could offer lower rates and offset those rates with loan fees.

A loan processing charge of $400 is the same as 1/4 point on a $160,000 loan. The lender makes the same amount either way; it's just that with the fee, its rates might appear lower compared to those of other lenders. The problem with this strategy is that all lenders have now adopted this practice and combined rates with their own set of lender fees.

There are usually two types of fees from a lender: required fees and "let's see if we can get them" fees.

For instance, a lender might tell its loan officers that it has two fees: a $300 processing fee, which goes directly to pay the loan processors, and a $400 administrative fee. The $300 is a required fee, while the lender will split the $400 administrative fee with the loan officer if the loan officer collects it.

The difference is that the processing fee is required, but the administrative fee is not; the lender just hopes to get it to increase the bottom line. However, you won't know whether a particular fee is required or optional. You won't be fortunate enough to be able to say, "Gee, David, you've got two fees here; which one of these can you waive?" and get a direct answer. But you do have to ask.

You can say, "Gee, David, I like your offering, but you're a little high on the closing costs; in particular, I'm not all that fond of your $400 administrative fee. If you waive that today, I'll go with your company."

The loan officer might either stammer a bit or come right out and say, "Okay, we have a deal!"

On the other hand, a required fee doesn't simply get waived; instead, it comes straight out of the loan officer's commission. With a required fee, a loan officer may not be so enthusiastic; in fact, she may decline your gracious offer and risk losing the deal altogether rather than continuing to close the loan but making only a few hundred dollars.

Another interesting twist about closing costs is that some of the costs are set fees, while others are based on a percentage of the loan amount. This is of particular importance when the loan amount of your property is relatively low.

For instance, on a $200,000 loan, 2 points is $4,000 potential credit to your closing fees. But let's say you have a smaller rental or a condo that perhaps has a loan balance of $70,000.

On $70,000, 2 points isn't $4,000 but $1,400. And the closing costs from the lender and the attorney alone add up to that amount. It's much more difficult to get a complete no-closing-cost loan when you're dealing with smaller loan balances.

If your closing costs, including all items from your lender, appraiser, title insurance, escrow—everything—add up to $3,000, when you divide $3,000 by the $70,000 loan amount, the result is 0.0429, or 4.29 points. You would have to increase your rate by more than a full percentage point to cover all the fees.

On the other hand, with a large loan amount, say, $750,000, you might have closing costs adding up to $5,000, yet that is only 0.0067, or 0.67 point, in "premium" pricing.

Mortgage brokers call this premium pricing the "yield spread premium," and it is the difference in spread from one rate to the next. Mortgage bankers also have premium pricing, but this is called the "service release premium," meaning that the lender will be selling the servicing rights to another lender at some point in the future.

If you have 0.67 point, this typically changes your rate by barely a breath, perhaps 1/8 percent, simply because points as well as origination charges are expressed as a percentage of the loan amount instead of as a flat fee such as that for an appraisal or an attorney charge.

All in all, with a median home price of $210,000 nationally, the rate/point trade-off works in almost every instance and should be considered at every opportunity.

It's important to note here that fixed-rate loans will carry more in premium pricing than adjustable-rate loans, and here's why: Lenders don't really begin making money on a mortgage loan until into the second year. This is because lenders have to pay their loan officers their commission and pay the processor and the office manager and pay for the telephones and computers and insurance and—well, you get the picture. So it's not until about the second year that the monthly interest payments become "net" income.

Red flags are raised when a lender sees an adjustable-rate mortgage loan without points, without lender charges, and without closing costs altogether. This loan has "early payoff" written all over it. If that loan doesn't make it into the second year, the lender will have lost money on it, even though the loan officer made her commission on it.

That's not any concern of yours; you can pay off almost any loan any time you want to. But an ARM coupled with no costs means lost revenue to a lender. A fixed-rate mortgage with no costs doesn't raise red flags, because lenders know that people who take fixed-rate loans typically intend to keep the property longer than those who take ARMs.

To offset the possibility of an early payoff, the lender simply doesn't offer as much premium on its ARM programs. The most one might find is sometimes only 1 point or so, usually what the loan officer would make on the transaction.

If you're getting rate quotes from lenders and brokers and you can't quite get to a no-closing-cost loan because of the lack of enough premium, this is the reason why. Lenders don't like to make those loans because they're money losers.

If you don't have enough premium to cover your costs, then forgo the ARM and go with a fixed-rate loan. Keep this option open. You'll need to run the numbers, but when it works, it works brilliantly.

First determine the ARM payment plus the costs you'd have to pay, then see what the payments would be with a fixed-rate loan and zero costs. Let's look at a $250,000 loan amount.

For an ARM, a $250,000 30-year amortized loan at a 5 percent rate means payments of $1,342 per month. Because there wasn't enough premium to pay all your closing costs, let's say you would get hit with $2,000 in closing fees.

Next, compare a $250,000 30-year fixed-rate loan at 6.25 percent; that payment is $1,539 a month, but it also means no closing costs because you were able to adjust the rate upward enough to offset all your closing costs.

The fixed-rate program is a better deal.

If you subtract $1,342 from $1,539, you'll be paying $197 a month more with a fixed-rate loan. However, you also had to cough up $2,000 for an ARM. By dividing that $197 into the $2,000 closing costs, you get the number of months it will require before the ARM would have made better sense than the fixed-rate loan because you held onto the property for too long.

In this case, if you go into the eleventh month, you made a mistake. But if you can flip the property more quickly than that, then the fixed-rate loan, even though the payment is higher, is your better deal.

Another word of advice with this strategy is that if you do it too many times with the same broker or lender, you might not find any takers.

You'll need to spread the love around a little bit in order to make this work consistently.

Just don't assume that an ARM is always the best option for the short term.

The Estimated Settlement Statement

Another critical time to review closing costs is when you're getting ready to close on your deal. A few days before your closing, you will receive your Estimated Settlement Statement. This statement is prepared by your closing agent and has a list of all charges and disbursements to both the seller and the buyer.

The Estimated Settlement Statement is so called because it's not the final statement. The final statement will come after your lender, the seller, and you have reviewed it. Sometimes you won't be able to see the estimated statement, only the final one.

Either way, you'll get to see the statement before you go into closing. Or at least you should. Sometimes things get backed up or someone forgets or people just end up being people and don't get that statement into your hands for a review. However, the statement tells you exactly how much you're going to have to bring in and also lets you review it to see if there are any mistakes.

It also lets you compare the final numbers with what your loan officer originally disclosed to you in your Good Faith Estimate of Settlement Charges.

If things are way off base, you need to put the process on hold and get these mistakes corrected.

Notice that I said mistakes. If your loan officer quoted $950 for title insurance and it's $990, that's a good estimate. However, if your loan officer quoted you $950 for title insurance and the final statement shows $1,950, either that's a mistake or the loan officer misled you.

This is also the time to review lender settlement charges as well to make sure that you weren't charged an extra point at closing time and that your interest rate is what you were told it would be. Getting the statement before you go to closing cannot be emphasized more highly. You need to be able to fix any errors before you go to closing; getting them fixed at the closing table (at least, getting them fixed on time and still making your closing date) may not be possible.

Good loan officers can give you a fairly accurate estimate. A good loan officer knows exactly what an appraisal will cost, how much an attorney's fee is, what an escrow charge is, and so on. This comes with both experience and honesty. Good loan officers stay in business for a long time because of those two qualities.

CHAPTER 7

Credit and Investment Real Estate

Credit is the cornerstone to financing your real estate investments. If you have excellent credit, you're guaranteed the best available interest rates, lowering your monthly payments and maintaining a steady cash flow.

Knowing how credit scores are established, corrected, and affected is critical to financing your investment properties, especially since owning properties will affect your credit score. Making the wrong choices or the wrong assumptions about your scores can affect not only the interest rate you get on a property but, more importantly, whether or not you even get approved for financing.

It used to be that granting credit to an individual was an arduous process. Someone would want to borrow money from a bank to buy some rental properties, and a bunch of folks would meet once a month or so at a loan committee meeting and decide whether or not that person was creditworthy.

Credit was typically issued via relationships with people or businesses that banks knew. If you wanted a loan, you would first get to know one of the bankers. If you had a loan from somewhere, you could get a loan from somewhere else. If you had never had a loan from anywhere, it would take you some time to get established.

In those days, the rich always got the loans because they had the relationships, established either through previous loans that they had had from the bank or through loans that their parents had had. It was hard to break through.

Fast forward to today. Underwriting decisions are made in moments, not weeks. There is no such thing as establishing a relationship with a banker in order to get credit, unless you're trying to procure an in-house or "portfolio" loan from a commercial bank.

Nowadays, lending decisions are greatly affected by a number, and that number is your credit score. Your credit history is the basis for this score and is the key ingredient in making credit decisions.

Credit scoring has been around for a long, long time. With credit scoring, you get so many "points" for paying on time, so many "points" for utilizing your credit responsibly, and so on, and in the past an underwriter would literally add up all your points and approve, or not approve, your loan.

Credit scoring these days is an ongoing and automated process. It's ongoing because it evolves with your everyday credit use, and it's automated because the algorithms used to calculate your score are preprogrammed into a scoring engine.

But let's back up a bit to see where credit reporting comes from so that you can understand how the score is calculated.

Where Credit Reports Come From

There are three main credit repositories in the United States. A repository is like a library, but instead of being a place where all the books are stored, it's a place where people's credit payment histories are stored.

The three repositories are TransUnion, Experian, and Equifax, and they are located in different parts of the country. They collect data from businesses and individuals that report those data.

I can see that at some point in the future, there will no longer be a need for three bureaus, but for now, that's what we've got. The reason there are three is that in the past, providing credit data wasn't so automated.

In the olden days, people in California didn't shop at home to buy stuff from Florida. People weren't as transient as they are now; people didn't move so often. We also didn't have national chains with multiple shopping locations throughout the country. Well, maybe we had a Sears store or a JC Penney store where we could order from catalogs, but back then that was about as "continental" as we could get.

When businesses made credit decisions, they would ask you to fill out a credit application. On the credit application, they would ask where else you had credit: the name of the store, its phone number or address, what you owed, and what the monthly payment was.

The owner of the store would then take your application, make some phone calls to the businesses you had bought stuff from on credit, and ask a few simple, albeit blunt, questions.

"Did David buy stuff from you?"

"Did and does he pay you on time?"

"How much does he owe you?"

"What are his monthly payments?"

And the all too popular:

"Would you lend to him again?"

If all the answers came back okay, then you would be able to buy on credit. On the proprietor's terms, of course.

This is a tedious process. If credit decisions were still made like this, we'd still be in the credit stone age. There would be no such thing as "instant approvals" and such. But it really used to be like this if you wanted to buy a car or a dishwasher. You would have to wait.

Eventually, businesses decided to play nice together and report credit patterns to a central database, the credit repository, where businesses could pull a credit history on someone just the way they would check out a book at a library.

Want to know about Joe Schmoe's credit? Don't call all the businesses Joe has borrowed from; instead, check out Joe Schmoe at the credit repository.

Businesses pay for that. They can't check out your credit for free. In exchange for pulling credit histories, they also contribute credit histories. There's a universal credit give and take.

That was the old way. Welcome to the new way: credit scores.

Along came an automated credit-scoring system that would pull your credit patterns, then assign your credit a number. The higher the number, the less likelihood that you will default. The higher the number, the better your credit; the lower the number, the lower your credit.

Credit scores can range from 300 to 850. I think the highest score I've ever seen was 810 and the lowest was around 440. An 810 score means that you have perfect credit patterns, are never late, make good utilization of credit, and have a long, stellar credit history.

A 440 means that some bad things have happened to you, such as bankruptcies and foreclosures and bad debt judgments.

Automated credit scoring was invented by Fair Isaac Corporation, commonly called FICO, which developed a system that analyzed a person's previous credit patterns and assigned that person a magical number, or score, automatically.

All three credit repositories use the same FICO method. But because not everyone reports to all three repositories, and even if they do, they may not report at the same time, these numbers are almost always different.

So if you get three different scores, which one do the lenders use? The middle one. They throw out the high score and ditch the low score.

They use the middle guy. Because of the geographical and enrollment disparities (not all businesses report to all three repositories, although most do), these numbers will vary.

How Do You Get a Credit Score?

You buy things on credit and pay the money back, and over a period of time your score will begin to appear on your credit reports. Credit scores take into account a variety of credit behaviors, then assign each particular behavior a number, and finally add up all the numbers and voilà!—instant credit score.

Credit scores are most concerned with the most recent two years' history, as that is most likely to be an indicator of what your next two years might be like. The components that make up a credit score are:

Payment history

Balances/available credit

Length of time in credit bureaus

Types of credit accounts

New accounts

Payment History

Your payment history, meaning whether you've ever been late and, if so, by how much, is the most important component of the score. Your payment history represents 35 percent of the total score.

Credit bureaus don't report whether you've been later than your due date; they report only if you've been more than 30 days, 60 days, 90 days, or 120+ days past due.

When you get a credit card statement, it could have a due date of, say, the twentieth of the month. If your payment gets posted on the twenty-first, while it would be considered late by the credit card outfit—thus possibly increasing your rate and incurring late charges—it wouldn't be considered late by the credit bureau.

There are simply too many due dates to keep track of, and this is the simplest, most convenient method to both report and review payments.

That means that if you were 29 days past the due date but not 31 days past, your credit score wouldn't get hit because you weren't more than 30 days past due. Granted, the cost of your credit will go up because you're past your due date, but for the purposes of calculating a score, it's not an issue.

More than 60 days past your due date? Your score will get hit again, and even more so than if you're 30 days late. The same occurs with a payment that's 90 and 120+ days past due.

If accounts go unpaid and then go into collection, that's still another markdown of your credit score. If the account is charged off, meaning that the creditor has written off your account as uncollectible, that's still another hit, and finally there's an additional hit if the account is sent to the courts for a judgment, meaning that there is now a public record reflecting the bad account.

If too many of these accounts are charged off or go to court, you might file for bankruptcy protection, which would be the final blow to your credit score.

But of course, you'll never get anywhere near that.

Balances/Available Credit

The next most important piece of the credit score pie is your available credit number, which compares how much credit you have available to you with the balances you owe and contributes 30 percent to your overall score.

If you have a total credit line of $10,000 on two credit cards and you owe $4,000, that's a pretty good ratio of balances owed to credit lines, or available credit. Ideally, the secret number is to have a balance of one-third of your credit lines, Do you have $10,000 available to you? An optimum balance would then be $3,333.

One interesting note about balances: Someone who pays off her debts each month, never allowing a balance to be reported to a credit bureau, can actually have a lower credit score than someone who keeps a balance, as long as that balance is at or below the 33 percent level.

This also means that closing out unused accounts can actually hurt your credit score rather than help it.

But what about mortgages? How do mortgages affect your credit scores if you put very little down? That's a good question, but fortunately for the consumer, mortgages are scored differently from revolving or installment credit lines. If you decide to put 5 percent down on a $100,000 duplex, you're not going to be hurt because the balance versus limit ratio is so much higher.

Credit Myths

These two anomalies in credit scoring run counter to what credit counselors and loan underwriters have suggested for years: Pay off your debt when and if you can, and close unused accounts. In fact, you could probably find articles or publications somewhere today suggesting just that.

While that might be a prudent method of keeping your credit under control, for purposes of scoring, it can be a negative.

Paying off debt and keeping zero balances means that you never reach the 33 percent balance to limit figure. And if you think about it, that sort of makes sense. When lenders extend credit, they want to be paid back, but they also want to make money while doing so. How will a lender really truly know if you can borrow money and pay it back over time if you never keep a balance?

Avoid going over your credit limit; this will also hurt your score and is a critical component of the available credit feature. Not only did you erase your available credit, but you made it go negative by owing more than the amount at which your credit limit is set. If you keep a balance that is perilously close to its limit, then one finance charge can put you over the top, knocking down your score.

And closing old accounts that have credit lines, an action that used to mean prudent credit behavior, can affect your balance to limit ratio, dropping your score.

For instance, what about that person with a total credit line of $10,000 on two accounts and a $4,000 balance? That's not bad; it's close to the 33 percent level. Now, close the account that didn't have the $4,000 balance. Let's also say that the closed account had a $5,000 limit.

Now you have a $5,000 limit and a $4,000 balance, or 80 percent of your credit line is used up. That will hit your score negatively, simply by doing what some people tell you to do: closing old accounts.

To keep your available credit, don't close old accounts; keep them open.

Notice that these first two score factors make up 65 percent of your credit score. If you concentrate on keeping these two items in line, almost everything else will fall into place. But if you're marginal or you have some credit concerns, you need to pay attention to the final three contributors.

Length of Time in Credit Bureaus

This means "how long have you been using credit?" and it gives you points for being a credit "veteran." It accounts for about 15 percent of your total score.

There's not really a lot you can do to affect this component except wait for time to pass. Your score will automatically adjust upward the older your credit file gets.

This is also another good reason for not closing old accounts. By closing old accounts, you're taking away some history and knocking your length of time component down.

Types of Accounts

Mortgages make up the biggest piece of this pie, followed by credit card accounts and consumer loans. These are called good credit accounts.

Not so good credit accounts are those from consumer finance agencies or other firms that specialize in lending to people with nonexistent or shaky credit, and this score component makes up 10 percent of your score.

New Credit

Opening up new accounts will hurt your score. So will having lots of different businesses pull your credit report for review. This component also makes up 10 percent of your score.

This means that if you don't think you have enough available credit, by opening up a new credit card to increase your credit, you'll also hurt your score at the same time by creating both a new credit inquiry and a new account.

How Real Estate Investments Affect Your Score

A flurry of new account openings could indicate some potential income or credit issues soon down the road.

Pay close attention to your new credit inquiry item. If you're an active buyer of real estate or you anticipate being an active buyer over the next 12 months, you might buy six or eight properties. That means at least six or eight new credit inquiries on your credit report.

Multiple or recent inquiries can hit your score, although not a lot by themselves—say, a couple of points each time you inquire. Credit inquiries over the previous 12 months hurt your score more than the total amount in 24 months.

This also indicates the importance of finding a good lender and sticking with that lender. Having fewer people inquiring into your credit report will keep your score up. Mind you, it's critical that you shop around for your best financing option, but after you've found a couple of regular "go-to" guys, stay with them.

It's also important to be serious about your real estate purchases. Don't take the plunge unless you're ready to swim the distance. Nonchalant credit inquiries will gradually erode your credit score.

One important thing to remember about inquiries: If there's more than one inquiry for a specific transaction, your score won't get hit as badly.

This means that if you're shopping for a mortgage lender and three lenders want to review your credit, as long as it's within a reasonable period, say 30 days or less, it won't be counted as severely as if you were applying for an automobile loan, a home loan, a new credit card, and a timeshare.

Inquiries for the same type of transaction will affect your score, but barely.

If you are gobbling up properties as fast as you can find them, with inquiries spread out over an extended period of time, pay close attention to the number of inquiries in the previous 12 months and try to spread your purchases or refinancings out over a longer period if possible.

If you have $1,000,000 to invest and you buy one big property with it, you'll have one or two inquiries on your report, depending upon how many lenders you solicit for bids. If you take that same $1,000,000 and buy ten $100,000 properties over 12 months, your score will end up lower than if you made the single $1,000,000 investment.

Inquiries by themselves normally won't hurt your score that much, as they account for only 10 percent of your score, but combining inquiries with any other credit item, such as going over a credit limit, will knock your score down dramatically.

You'll notice that there is no single "fix" in these score categories. Sometimes trying to fix one part of your score can hurt you in another. That's why the score doesn't just look at today, but gives the most weight to the previous two years of history.

In fact, about three-quarters of your score reflects your most recent two-year period, whereas little or no account is taken of anything beyond four years. You can have an outstanding collection account that's five years old, but if nothing has happened to it, including paying it off or down, then it's likely that the negative item could remain on the report without affecting the credit score.

Most conventional loan programs underwritten to Fannie Mae or Freddie Mac standards do not have minimum credit score requirements. You heard that right; there is no such thing as a minimum credit score for most conventional loans.

There are certain "boutique" loans with no money down or first-time home buyer programs that do need a minimum score, but in general, you shouldn't get too hung up on your score, unless you need an alternative loan.

Alt loans typically do require a minimum score, usually around 620, but this can be offset by putting more money down or borrowing less or going fully documented instead of stated (documentation levels are explained in Chapter 8). But the score is required nonetheless.

Another type of loan that requires a minimum credit score is loans reserved for the "nonprime" or "subprime" borrower.

Subprime Lending

Subprime loans are designed for people who have had their credit damaged and need an alternative for financing. Subprime loans carry higher rates than conventional or alt loans, but they are there if needed. They should be used only in the short term.

Using subprime lending to acquire investment property needs to be examined closely, but sometimes when properties come up at a time that coincides with a negative credit item on someone's credit report.

How much higher are subprime loans? That depends on your credit score. The lower the score, the higher the rate, but most subprime loans start out at about 2 percentage points above similar loans reserved for those with good credit, so if a good rate is at 6.00 percent, a subprime loan will be around 8.00 percent. For people with badly damaged credit, rates can be 4 to 5 percent higher. Subprime lenders also categorize their subprime loans with a letter grade, typically from A+ to C−, with A+ being the highest grade of subprime and C− being the lowest.

For marginally subprime loans, those with an A grade, the borrowers have a few features in common:

High loan balances to available credit

Late payments

Paid collection accounts

Credit scores from 600 to 650

Borrowers of B loans have the same features plus:

Outstanding collection accounts

Judgments

Credit scores from 580 to 600

Borrowers of C loans reflect the same features plus:

Recent bankruptcy filing or discharge

Foreclosure

Repossession

Because a grade of C and probably B makes loan acquisition too expensive, these loans are probably less of an option for financing a property and more of a wake-up call that if you're going to get into the real estate investment business, you first need to fix your credit.

Subprime lending fills a need; it is designed not for chronic credit abusers, but for those who typically have had something bad happen to them, such as losing a job, a divorce, a long-term illness, or, worse, a death in the family.

The typical subprime loan is issued to someone who has had good credit up until a certain point, but then was laid off and couldn't find work, or someone who had an extended illness that wrecked her finances.

Subprime loans are a temporary solution, not a permanent one. This means that while there are lower subprime rates available to you by paying points, the best strategy is to obtain the subprime loan, repair your credit, then refinance later into a conventional loan.

This is why the most prevalent subprime loan is a hybrid with a 2/28 or 3/27 term, meaning that the rate is fixed for two or three years, then turns into a straight ARM for the remainder of the 30-year term.

Subprime margins can be pretty scary—as much as 5, 6, or 7 percent or even more. That's why it's vital that when you take a subprime loan, you do everything you can to get out of it before it adjusts.

You can find subprime loans pretty much anywhere you can find regular loans, but you need to take extra precautions because there are some unscrupulous mortgage brokers who will take advantage of your credit situation and charge you lots of fees and points, making you think that they're the only ones who will approve your loan given your circumstances.

But nothing could be further from the truth. Subprime loans have standard underwriting guidelines just as conventional or government loans do, meaning that you can get the exact same subprime loan from one lender as you can from the next.

That's why I recommend staying away from companies that specialize in subprime lending; instead, work with a mortgage company that you know and ask for its subprime division. Almost every mortgage banker in the business has a unit dedicated to subprime lending.

Bigger lenders and banks typically have a maximum amount of money that can be made on a particular loan, while mortgage brokers may not have any such standard. And since your plan is to refinance out of the subprime note in a short period of time, say two years, it's essential that you pay no points and, if possible, no closing costs.

Subprime loans also can carry a prepayment penalty, or an additional amount of money that you will owe the lender if you pay off the mortgage early or make extra payments on the mortgage note.

Most prepayment penalties coincide with the initial fixed hybrid term, say two years for a 2/28 loan, but they can last as long as the loan agreement allows.

Repairing Your Credit

So how, then, do you fix your credit if it's been damaged? First, do not use a credit repair service.

Credit repair services don't do anything that you can't do, no matter what they tell you. There is no "secret system" for taking things that don't belong there off your credit report. The credit-reporting system is too dynamic these days to respond to simple "verify or remove" contests, where a borrower would contest a negative item and hope that the response took longer than 30 days, meaning that, according to fair credit laws, the negative item would have to be removed, whether or not it was valid.

If this didn't work the first time, the borrower would start all over, eventually (hopefully) removing the negative item.

Mistakes can be removed, but only if you have documentation for the mistake. I recall a lady who had a Chapter 7 bankruptcy discharge reported on her credit that was a mistake. It wasn't a discharge; it was a dismissal. There's a big difference. She had simply decided that she didn't want to file for bankruptcy after all and dismissed the filing. That was a mistake, and she could document it.

But by taking this process one step further, she got her credit report fixed in one day. Actually, it was less than one day, because I was the one who helped her get the item fixed.

Mortgage companies are customers of credit-reporting agencies. These agencies hire sales representatives and customer service reps who do nothing but make lenders' lives easier. One of the services they offer is correcting a credit report quickly as long as the lender can provide third-party verification of the error.

Consumers can do the very same thing, but it normally takes longer. You have to call here and overnight there and be put on hold, then voicemail, then whatever. It can take forever because you're one of millions of people in the credit system and you're really not the agencies' customer.

But lenders are.

A lender can do what you or a credit repair service can do, only more quickly and for free.

But what happened to my client's credit scores after the bankruptcy had been erroneously reported on her credit report for so many years? After all, her scores were artificially depressed because of that major error.

Let Your Lender Fix it Fast

There is a feature called a "rapid rescore" where a credit-reporting agency will take the corrected information and rerun the score as if the mistake had never been there. It takes about three days and costs around $25 per line item, per bureau.

I rescored my client on just one line item, the bankruptcy, and asked for the rescore from two bureaus and not three, which saved my client another $25. Why did I order only two bureau corrections? Because lenders use only the middle of three credit scores, and by ordering two, I would get my middle score while still throwing out the lowest one.

It worked, and my client's credit scores increased by nearly 80 points.

To repair your credit, remember that you must have third-party documentation, not a heart-rending letter explaining your side of the situation. Credit agencies don't provide the information that's in your credit report; they only report it. It's someone else who put the data in there in the first place. For a credit-reporting agency to remove something, you have to have verifiable proof.

If you're going to invest in real estate, then good solid credit is a must, and you have to manage it. Keep an eye on your report regularly, and be on the lookout for mistakes that can damage your score without your knowing it.

Lenders can review your score and provide you with worse terms than you thought you would get, all because you weren't actively monitoring your credit.

CHAPTER 8

Documentation of Assets and Rental Income

Earlier in the book, you heard me use the term *degree of documentation*. This simply means how far the lender will go to verify the information you put on your loan application.

This is important because each lower degree of documentation can either require you to put more of your own money into the transaction or increase your interest rate (which could affect your approval), or a combination of both.

Before we go any further, this does *not* mean that you can lie on your application up to a certain point; instead, it means what type of loan you can get approved for based upon the loan requirements being presented.

For instance, a conventional loan could require verification of rental income from other properties in previous years before the rental income on your new property can be counted. But a no income verification loan won't have such a requirement. You have the income from the property you're going to buy, but because of the particular lending guideline, the lender can't use that income to qualify you for a conventional loan.

So you switch to a loan program where verification of that income is not a requirement.

There are different degrees of verification, and these degrees are:

Fully documented, or full doc

Stated income/verified assets, or SIVA

Stated income/stated assets, or SISA

No income verification, or NIV

No income/no assets, or NINA

No income/no employment/no assets, or NINENA or no doc

Fully Documented Loan (Full Doc)

Plain and simple, this means that everything you put in your application regarding your income, assets, and employment is verified by third parties.

Yes, you completed the application, but the lender won't take your word for it that you make $10,000 per month; instead, it will ask for verification from a disinterested third party, such as the IRS or your employer.

When you verify your income, the lender may ask for tax returns for the previous two years to show how much money you made and also look at your W2 forms for those years.

Most often the income tax requirement is for the self-employed, but it doesn't always have to be, especially when verifying rental income is involved. The lender will also ask for a couple of paycheck stubs covering a 30-day period if you're not self-employed.

Having stubs covering 30 days allows the lender to accurately calculate your debt ratio, or your gross monthly debt divided by your gross monthly income. A W2 and pay stubs provide the third-party verification that the lender needs in order to document how much money you make.

Fully documented loans also verify your assets, meaning both liquid and nonliquid accounts. Liquid accounts are accounts where you can get the money immediately, whereas nonliquid accounts would include things such as CDs that haven't matured, 401(k) or IRA plans that you can't access without penalties, and other such instruments.

Lenders have to make certain that you have enough money to close the deal, and they do that by reviewing bank and account statements for the previous three months. Lenders demand that the funds needed to close on an investment loan be yours and yours alone. If they review one of your bank accounts that has the $20,000 you need to buy the duplex you have your eye on, the lender will scrutinize the statements, looking for any large deposits that are inconsistent with your income.

This is done to make certain that you're not borrowing from Peter to pay Paul, so to speak. If you need $20,000 to close on a loan, and the lender sees a $20,000 deposit when your job pays you only $7,000 per month, the lender will ask a question: "Where did this come from?"

At first glance, you might say, "What business is it of yours?" but in reality, the lender has a good reason for asking that question. If that $20,000 has suddenly popped up, do you now owe someone else that money? Do you have to pay it back? If you do have to pay it back, then your debt ratio could be skewed.

If you borrowed it, does the person you borrowed it from have an interest in the property that would affect the new lender's loan?

Another aspect of sudden large deposits is that the lender would really like to see a consistent pattern of savings to come up with a real estate investment. This shows some discipline and is usually a reflection of an overall solid profile.

Lenders can also verify via third-party means, using forms called verification forms. Verification forms are sent to your bank or your employer or whomever the lender needs information from and are completed by filling out boxes on the forms that ask, "How much money is in this account?" "What is the average balance for this account?" and other such questions.

For your employment, the form is typically sent to the owner of the company or the human resources department, asking similar verification questions, such as "Does she work at your company?" "How much does she make?" and "How long has she worked there?"

This form is completed by the bank or the employer, then mailed or faxed back to the lender who is asking all those questions.

Stated Income/Verified Assets

A stated income/verified assets (SIVA) loan means that whatever income you put on your loan application is what the lender will use to qualify you. If you state that you make $8,000 per month, the lender won't send any verification forms to your employer, won't ask for pay stubs or W2 forms, and won't require you to send in tax returns. The lender trusts you.

However, the lender on a SIVA will verify your assets. That means that you need your three months' most recent statements covering your bank, investment, and/or retirement accounts.

SIVA loans are the next highest degree of verification. SIVAs don't mean that you can lie on the application; they simply mean that while you make that money, it doesn't qualify under the lender's fully documented loan guidelines. You still need to make the payments, so whatever you put down on the application still needs to be real.

For instance, if you put down that you make $50,000 per month on a loan application, thinking that you can now qualify for that million-dollar loan, but in reality you make only $5,000 per month, then how in heck can you afford the new mortgage? At 7.00 percent, the payment on a million-dollar loan is nearly $7,000, or $2,000 more than you really make.

Lenders can also look at a SIVA and by reviewing your assets make a roundabout determination as to whether or not your stated income is realistic. If you report that you make $12,000 per month, and you have zero debt but only $500 in the bank, then there's something really wrong with the application.

With a SIVA loan, lenders may also require that at least six months' worth of PITI, or principal, interest, taxes, and insurance, be verified in a liquid account.

If the property you're buying has a total payment of $2,000, then the lender will want to see account statements verifying that you have $12,000 in the bank above and beyond what is required to acquire the property.

Stated Income/Stated Assets

Stated income/stated assets (SISA) loans are one rung below a SIVA, meaning that neither your income nor your assets are verified. If you put down that you make $10,000 per month and have $50,000 in the bank, then the lender will use those numbers to evaluate your loan request.

Lenders also use some common sense when evaluating a SISA loan. With a SIVA, a lender can look to see if there are liquid assets that could justify a $50,000 per month income, for example.

With a SISA, the stated income and stated assets must be in line with the kind of work you do. If you're a kindergarten teacher making $5,000 per month, hey, that's reasonable in California, but it may not be reasonable in Oklahoma.

If you're a kindergarten teacher and you claim that you make $12,000 per month and you have $100,000 in the bank, then the lender may not approve your loan request because the stated income and stated assets must be in line with your work.

No Income Verification

With this loan type, no income whatsoever is put on the application. Instead of stating an income amount on an application, you leave the income section of the loan papers completely blank.

That also means that no ratios are calculated. Your employment will be verified with a phone call or other type of verification. If you're self-employed, NIVs will require you to have been in business for at least two years.

With an NIV, the lender will ask you to provide a letter from your CPA claiming that you've been in business for more than two years. The letter won't mention anything about income, nor will the CPA be asked to provide tax returns; he will only certify that you've been self-employed for a minimum period.

With an NIV, however, assets are verified and also must be in line with the work.

No Income/No Assets

The next-to-last level of documentation is the no income/no assets (NINA) loan, where both the income and the asset information are left completely blank. No ratios are calculated, and no reserves are required.

The lender will verify that you have a job and may also verify how long you've worked at a particular company or ask for third-party verification that you've been in business for more than two years.

You don't have a CPA, and you've always done your own taxes? Do you have a receipt somewhere for advertising with your company name on it that is more than two years old?

Did you place an advertisement somewhere? Do you have a business license that is dated more than two years ago? You can get creative to meet the requirements for a two-year employment history.

No Doc

The only thing that is verified for this loan is that you are who you say you are; all income, asset, and employment information is left blank.

There's not much more to add here except that this is the absolute lowest degree of loan verification there is. It also commands the highest rates and requires a larger down payment than any of the previous documentation types. That's the trade-off when you reduce documentation. At first glance, you'd say, "Heck, why doesn't' everybody just fill out a no doc and move on?" The answer is that it gets expensive.

When a lender agrees to relax some lending guidelines, the lender will offset those relaxed guidelines with a higher rate of return—meaning a higher interest rate. Here is a typical trade-off between a fully documented loan and other types, all the way down to a no documentation loan:

Program	**Change**
Full doc	No change
SIVA	From full doc, increase points by 1/4 and increase down payment by 5 percent
SISA	From SIVA, increase points by 1/4
NIV	From SISA, increase points by 1/4
NINA	From NIV, increase points by 3/4
No doc	From NINA, increase points by 1/4 and increase down payment by 5 percent

Let's take a $200,000 sales price with 20 percent down as an example. A full doc loan asks for $40,000 as the down payment.

The SIVA asks for $500 in points plus another $5,000 in down payment.

The SISA asks for yet another $500 on top of the SIVA.

The NIV asks for $500 more than the SISA requires.

The NINA asks for $1,500 more than the NIV needs.

The no doc asks for still another $500 plus another $5,000 in down payment.

The difference between a fully documented loan and a no doc loan is $13,500. This doesn't even take into account credit scores. Lower credit scores can also mean more down payment, more points, or a combination of the two.

Loan documentation levels can also be a matter of convenience. I recall a client who had a hand in several businesses, some limited partnerships and some corporations. His income tax returns were literally nearly eight inches high. And this guy made some pretty good money.

I financed some property for him using a stated income/stated asset loan because it was easier to qualify for and the difference in monthly payment was marginal.

I have had other clients who had a variety of mutual funds, stocks, and retirement accounts with lots of account statements—as many as twenty or more. Instead of trying to verify each and every account, we went stated assets and forgot about trying to verify everything that was there.

Going stated also means that a higher down payment may be required, as well as an increased rate or fees. If you don't want to verify your income or assets in any way whatsoever, then you'd better have a pretty good reason for doing so because it will make it much harder to have good cash flow.

Higher rates as a result of lower documentation levels mean higher mortgage payments and less (if any) net rental income. If you're flipping the property rather than holding it, it might be a good idea to take the higher rate if you don't want to dig through all your tax returns, bank statements, and stock account statements because you won't be renting the property—you'll simply be acquiring it, fixing it up, and selling it within a short period of time. Just remember that this convenience has a price, and it's you who pay it.

Documentation levels have certain clients that they fit and are designed to streamline the loan process.

Documenting Income

Income that is used to calculate debt ratios can come in a variety of flavors. Some people are self-employed, while others work for someone else. Some have interest income, and some get pensions or annuities.

Some play baseball six months out of the year. Some write books. Some are professional gamblers. Some are nurses who work for several different hospitals on a contract basis. Some sell cars. Or yachts.

The fact is that different people get paid in different ways, and for each of these ways there is a method of verifying income. Furthermore, some income can't be counted because it doesn't fall into the qualifying income category.

Let's break down the different types of income and how each is verified and used by lenders to evaluate a loan application

W2 Income

This is the most common form of employment income. You work for a company on a salary or on an hourly basis, get a regular paycheck with all its withholdings, and get a W2 at the end of every year.

Your income is verified by third parties, meaning that your employer sends both you and the IRS a statement showing how much you were paid during the past year. This is the easiest type of income to document. Lenders love W2 income because it streamlines the process and no other verification is required.

W2 income also comes with another benefit: pay stubs from your employer.

When you get a paycheck, your pay stub will show how much you get paid and how often. If you get paid by the hour, it will show an hourly rate and how many hours you worked. If you get a salary, it will also show your gross earnings for that period and what time frame the period represents.

For instance, if you get paid on the first and fifteenth of the month, the pay stub will reflect both the amount paid and for what period, such as, "from 10–01 through 10–15."

A not-uncommon confusion occurs when people get paid every other week, yet still think of two pay periods as their "monthly" income.

If you get paid $3,000 every other Friday, you don't get paid $6,000 per month, although I still see loan applications filled out that way. When this happens, the borrower is short-changing herself.

If you get paid $3,000 every other Friday you make $6,500 per month, not $6,000. When you get paid every other week, your annual income is calculated by multiplying your gross monthly income by 26 (52 weeks divided by every other week) then dividing by 12 (months).

In this example,

$$\$3{,}000 \times 26 = \$78{,}000 \div 12 = \$6{,}500$$

Why is this important? If you want to buy a property that the lender thinks is out of your reach, make sure that the loan officer is calculating your income correctly. Most of all, make sure that you complete the loan application correctly yourself so that there'll be no mistake.

I've seen too many cases where the consumer puts down the wrong income information and the loan officer doesn't double-check the figures. Watch out.

The Self-Employed Borrower

After you've built your real estate portfolio to the point where you want to quit your current job and move into real estate full time, be prepared for a new way of documenting your income and some new rules that will apply to you.

When you're self-employed, the lender first and foremost wants to see that you have been self-employed for at least two years.

This is the part that most frequently trips up real estate investors;

they quit their job, then apply for a new home loan (one that they had been approved for in the past), but now, since they are newly self-employed, they haven't been self-employed for two years and are declined.

How does a lender know that you've been self-employed for two years? Can't you just say so? No, you really can't. That's a stiff guideline, and for a couple of reasons.

First, the lender wants to know if you're successful at being self-employed. Can you make money on your own instead of working for somebody else and getting a regular paycheck? Second, and just as important, can you also run a business as well as being profitable?

Those are two very important questions.

Sure, you need to make money. All too often, businesses look between the sofa cushions for expenses to write off, including mortgage interest and property taxes. But other payments, such as vehicle expense, entertainment, client lunches, and insurance, suddenly become tax deductible for many of the self-employed.

You need to make enough money to cover all your mortgage interest, property taxes, maintenance, and other business expenses and still show a profit. The lender won't use your gross rental income (income before all your deductions) to qualify you; the lender will use your income after all your deductions.

If your deductions eat too much into your gross profit, you could find yourself not being able to qualify because your net income is reduced.

Second, as well as making a profit, the lender wants to see your ability to run a business. Are you making money from one year to the next? Are you showing increased income from one year to the next? Is your business growing or shrinking?

Lenders will examine your tax returns for consecutive years, looking for increased income—and definitely not a loss. That's one of the reasons that lenders require two years' tax returns from self-employed borrowers.

One interjection here: If you've been self-employed for several years and the past two years weren't as good as the previous years, then feel free to provide three years' tax returns.

Lenders will average your previous two years' income for loan qualification purposes. If you made $80,000 two years ago and $100,000 last year, the lender won't use the $100,000; it will use the average, or $90,000.

Sometimes a business simply has a bad year. If you made $80,000 two years ago and $40,000 last year, the lender not only will drop your income to $60,000 but could also be very wary as to why there was a 50 percent decline in income.

"Is there a problem here?" the lender might ask.

But if you also show that you also made $75,000 three years ago along with the $80,000 and $40,000, you can make a case that the $40,000 was an aberration by providing additional tax returns and an explanation of what happened during that "down" year.

"I bought additional properties that year before I had them rented" or "I had some significant one-time repairs to a property" or some similar answer will suffice.

Being able to not only make money but manage the nuances that a self-employed person has to deal with is part of the package. Some people can make money at a business, yet run it into the ground because of bad management.

What if you make a stated loan application while you're self-employed and the lender wants to see your two-year history of self-employment?

Providing tax returns won't help because a stated income loan doesn't use tax returns.

Lenders will accept a letter from your accountant that says something like, "I'm Sally the CPA, and I have done David Reed's taxes for two years, and he has been self-employed during that time."

This "CPA letter" is common in such instances. The lender just wants to see verification from a third party (your CPA) that you meet the minimum two years' requirement to be self-employed.

You don't use a CPA? Then some other verification will work, such as a business license with your or your company's name and date on it. Heck, I've even used a Yellow Pages ad from a two-year-old phone book.

But here's a trick: Don't quit your day job while you're beginning to invest in real estate if you're planning on becoming a full-time real estate investor. Instead, acquire your property, collect your rent or flip your houses, and do it for a minimum of two years.

Your tax returns will show this self-employment income while you're still working at your current job, and you can have the best of both worlds—getting into real estate investing while qualifying for the lender's two-year minimum self-employed guidelines, all the while still keeping your "normal" job!

Rental Income

Using rental income has a few twists of its own.

For self-employed borrowers, lenders will use tax returns to show rental income, which is reported on Schedule E in the return, then again average it over the previous two years.

For others, a lender will use a lease agreement as verification of rental income, sometimes along with some bank statements showing rent deposits.

If you get $1,500 per month from a rental, a lender will want to look at a lease agreement that states that amount. Knowing that lease agreements can easily be manipulated, it may also look for bank statements showing a $1,500 deposit on or about the first of the month, or whenever rent is due on the property.

If your renter pays you $2,000 per month, be prepared to provide not just the lease agreement but your three most recent bank statements showing a separate $2,000 deposit. If your renter pays you in cash, be sure to deposit that cash in a bank account if you think you'll need that income to help qualify you for future loan applications.

Furthermore, if you're applying for a mortgage and you have damaged credit, a lender can ask for 12 months' bank statements showing that $2,000 deposit. In fact, a lender can ask for just about anything it wants to ask for as long as what it asks for is necessary to approve the loan and it applies that same guideline to everyone, regardless of sex, color, or creed.

There's also a twist as to whether a lender will require tax returns or a lease agreement to verify income. If you acquired the property after you filed your most recent tax returns, the lender will most often use a lease agreement and not the tax return.

If you acquired the property before you filed your most recent tax return, the lender will want to see that tax return to see what you showed as income. You'll also want to keep a copy of your settlement statement that will reconcile the income received from your rental property from the time you bought the property.

If your tax return shows $5,000 in income from last year, but you owned the property for only two months, have your settlement statement handy to show that you bought the property in October and received rental income for November and December. Receiving $5,000 for two months equals $2,500 per month, whereas receiving $5,000 for twelve months equals $417 per month. That's a big difference.

When lenders don't require tax returns for rental income, they'll simply adjust your gross income lower. They'll do this by multiplying your gross rental income by 25 percent and subtracting that figure from your gross income rather than using the full figure. This 25 percent reduction covers maintenance, vacancies, and other deductions commonly associated with rentals.

If you show on your loan application that you receive $1,000 per month in rental income, the lender will automatically deduct 25 percent of that and give you $750 per month for qualifying purposes. This can lead to a loss and a potential problem if you need rental income to qualify you for a new mortgage.

Suppose your mortgage payment is $1,000 and your rental income is $1,000 per month. You're breaking even, right? Wrong. With a deduction of 25 percent, your income is $750 per month, and you now have a "loss" of $250 per month.

Instead of gaining $1,000 to help you qualify, you are now adding $250 to your liabilities. It's not a wash, it's a bill.

In addition, lenders use your property taxes and insurance along with your mortgage payment to determine net income. Principal, interest, taxes, and insurance, or PITI, is the number used.

Now take a $1,000 mortgage payment plus $150 in property taxes per month and $50 for property insurance, and the PITI figure is $1,200.

You need to collect $1,600 per month to break even. Deducting 25 percent from $1,600 gives $1,200. Then deduct taxes and insurance of $200 per month, and the qualifying rental income is $1,000. Break-even.

Do you need the rental income from the property you're considering buying to help qualify you? Can you afford the new mortgage without rental income?

Unless you have experience being a landlord and collecting rents, managing properties, and everything else that goes along with that, most lenders won't use rental income to help qualify you. No experience, no income.

There's also a problem if you want to use the potential income from a property to help qualify you. For instance, suppose you have been a landlord for more than two years, and you can prove it from your tax returns along with signed lease agreements. However, the property you want to buy is vacant and there is no income stream.

Lenders will not use anticipated income from a rental to help qualify you; there has to be income already there. Just as a lender wouldn't qualify someone based upon using anticipated income as employment income—the person getting a well-paying job—neither will anticipated or expected rents be counted.

Documenting Assets

A fully documented loan that lists assets will need to have those assets verified by third parties; normally that means by your bank or investment institution. Verification comes from two basic sources: through a verification of deposit, or VOD, or by providing statements from the accounts.

A VOD is a written request from the lender to the bank or investment company asking:

Does this account belong to the borrower?

How much is in the account?

What is the average balance in this account?

The first question is easy to understand, and so is the second. But the third question also reveals another verification secret that lenders like to use: the average balance.

Lenders want to see down payment money come directly from you and your own assets. You can't borrow from someone else to put money down on a property on which you want to borrow still more money.

If your current checking account shows a balance of $75,000, then that's good, right? But lenders also ask for an average balance over the previous 90 days. If the average balance is much less than $75,000, that could indicate that those funds were borrowed from someone else, creating a possible secondary lien on the property you want to invest in.

For example, if your current balance is $75,000, but your average balance over the most recent 90-day period is only $25,000, then there must have been one huge deposit during that 90-day period to bring the current balance up so high. In this case, around $67,000 was deposited at some point during that 90-day time frame to both add to the current balance and adjust the average balance.

Lenders will want an explanation of the origin and terms, if any, of the large deposit.

Another way lenders verify assets is simply by looking at your bank or investment statements. This is easy enough and the least time-consuming way to do this. Upon application, you provide those bank statements to your lender to show that the money is in the bank or investment account. That way, the lender won't have to fill out a VOD form and send it to your bank.

Remember, though, that if those statements show a $67,000 deposit, you need to be prepared to not only explain but verify the large deposit, just as you would have to with a lender-prepared VOD.

One interesting note here: The better your credit, the fewer statements you may have to provide. If you have excellent credit along with solid debt ratios, a lender might not ask for three months' statements, but only for your most current one. If that's the case, there won't be any sign of a large deposit if the deposit occurred before your most recent statement.

I recall a client who lives in Colorado who bought a condo in Austin, Texas. He provided a statement from one of his accounts that showed a rather large single deposit, of over $500,000.

The underwriter wanted to know where the deposit came from: Was it a loan? My client's credit scores were in the high 700 range, so he needed to provide only one statement, his most recent, and not three.

In fact, it wasn't a loan; it was a retirement disbursement from his previous employer in California, where he had worked for nearly 20 years. The money was perfectly legitimate; it was just that now we had to provide documentation of the source of those funds.

The money had been distributed to him recently, so he needed to get a statement from his previous employer showing how much he was to get and match that amount with what was deposited.

The interesting thing about this verification process was that when he first sent in his statement, he was in between statements and would soon be getting his new one—the statement that did not show the huge deposit, but only the current balance.

Instead of providing yet additional paperwork from various sources tracking down the retirement disbursement, we simply waited for the next statement, which showed only the balance, and provided an explanation letter covering the difference between the two statements.

We did not have to provide third-party verification of the source, as the client had to provide only the most recent statement. Since there was no large deposit on the most recent statement, we didn't have to explain it. Actually, since the underwriter had already seen the deposit on the previous statement, we did have to explain it, but we didn't have to go through reams of additional paperwork to verify the source of the large deposit.

One last item regarding assets: There are liquid and semiliquid assets that lenders can use to determine whether you have enough money to qualify. Liquid assets are those that you can access at your leisure: bank accounts, stock accounts, and such.

Semiliquid assets are IRAs, 401(k) rollovers, or other retirement accounts. The lender won't make you cash them in but will normally give you credit for 70 percent of the amount noted on your retirement statements.

If you have a 401(k) balance of $100,000, then your lender will credit your application with $70,000 in cash reserves, as this is the approximate amount you would receive after penalties and taxes paid on an early 401(k) withdrawal.

This is important when documenting cash reserves is a requirement of your approval.

Keep Records at the Ready

This brings us to the final part of documentation: Be prepared.

Knowing ahead of time what your lender might ask for means that there'll be less stress during the loan application process. Keep copies of everything, and simply have your very own "mortgage application file" available each time you need it to buy investment property.

At a minimum, keep on hand:

Two years' most recent tax returns, with all schedules

Last two years' W2s and 1099s

A year-to-date profit and loss statement

Three months' most recent statements, all accounts

All lease agreements

All settlement statements from previous sales

Copies of current insurance coverage with premium amounts

Copies of current tax bills showing property taxes

If you keep this information at your fingertips and also current, you'll never be concerned with finding this or locating that—it'll be there when you need it.

All that having been said, do *not* provide all of this documentation at the same time you apply for the mortgage loan; instead, wait until your lender has reviewed your initial loan application.

Mortgage loans used to be underwritten manually, one by one. In the olden days, mortgage loans were documented and verified first, then submitted to the lender for approval.

Now, however, mortgage loans are approved using an automated underwriting system, or AUS.

Loan Approvals in Minutes

With an AUS, either you complete a loan application by yourself online or your loan officer completes it for you, and then the information is electronically submitted to an automated system that automatically "approves" your loan by calculating debt ratios, pulling credit scores, and looking at listed assets.

This process takes only a few moments. Your information is input into the system, and along with your approval, the system gives a list of the things you need to provide—*after* your loan is approved, not before.

The better your loan profile, the less documentation you will have to provide. If you have excellent credit and solid assets, you may have to supply your bank statements for only one month instead of three. Or the AUS may ask for only one year's tax returns and not two. Or none at all.

The benefit is twofold: The lender reviews only the information required to approve the loan, not every last piece of documentation you've ever had to produce (lenders don't like paperwork either), and you provide only the minimal amount of documentation needed, which also saves you time. But it can also save you more headaches, and there is probably a nice, middle ground.

Each time you apply for an investment loan, you're examined all over again. And if you rate-shop lenders every time and pick the best lender, who might be better in total loan cost by $200, you'll find that you may be providing the same explanations about past income or providing the very same lease agreements or hazard insurance policies.

That's fine as long as you don't start pulling your hair out. From a lender's standpoint, we want loans to go quickly and smoothly as well, but we also want to be within lending guidelines and to make good loans.

As a lender, I want to spend less time dotting i's and crossing t's, and more time getting my clients into properties with the best rates and terms I can, along with the least amount of headaches.

If you have good credit and an initial equity position of 20 percent down, it's smooth sailing for me. And most important, it's smooth sailing for you.

You'll know after your first few investment purchases which level of documentation is best for you, but I can tell you that a stated income, verified assets is perhaps the most convenient in terms of the trade-off between price (minimal, if any), time to close, and paperwork required. This is especially true if you own multiple properties with various income streams.

CHAPTER 9

Creative Financing for Real Estate Investments

There are other sources of financing, ones that don't come from Fannie Mae, Freddie Mac, or alt lenders. In fact, "creative" can simply mean applying existing loan requirements in another, albeit legal, way.

Let's take a moment here first and make it clear that *creative* doesn't mean fraud. Suppose you have a loan officer who says something like, "You know, we might have to get a little creative here to get this thing done."

Run, don't walk.

Falsifying a mortgage application to qualify for a home loan is a felony. Money crosses state lines, making it wire fraud. You sign a loan application that asks you to say, in various formats, that what you're telling is the truth, and so on.

The problem with loan fraud is that the result isn't merely a slap on the wrist or the lender saying, "Oh, that's okay; we really want to make this loan, so we'll overlook the fact that you inflated your income."

Loan fraud has become front and center one of the main focuses of the FBI and state regulatory agencies.

Fraud has become easier to accomplish as a result of the advent of new types of mortgage loans, specifically the stated documentation loans mentioned in the previous chapter. Even if fudging an income amount seems harmless, the consequences can be worse than just losing a property.

For instance, let's say you and your partner decide to buy your first rental property, and you need both incomes to qualify. So both of you apply, and you find out that your debt ratios are too high to qualify for the property you want.

Then you decide, or perhaps your loan officer suggests, that you will instead apply for a stated loan and have your partner put down $10,000 per month income instead of $5,000 per month. Even though this isn't the case, eventually you'll probably make that amount, right? At least, that's what your loan officer is telling you: "Aw, come on. Everybody does it; just put it down; nobody will check it, and you'll own that new property, and besides, you'll make that one day anyway, won't you?"

"It's really not lying if someday you do make that amount. And if you don't buy now, the property will be worth $20,000 more in six months, and by that time you'll have sold it anyway." Says you and the loan officer.

Several things happened during this discourse, but the main ones are that the loan officer told you how much to put on your loan application so that you could qualify, and you agreed and completed the application. So far, both you and the loan officer have committed fraud.

What's interesting about this scenario is that the lender the loan officer works for probably doesn't know about the misstatements. In fact, the lender probably never saw the previous application because the loan was declined and sent to the lender's storage vault in accordance with regulations.

When the new loan application appears, with the brand-new qualifying income, it's simply seen as a new loan application that qualifies for the stated income and asset loan.

You apply, you get approved, and then you move on.

But wait—something happened while you were busy making plans. Your partner lost his job and no longer has an income, not even the one he had before he falsified it. And you can't sell in six months as you intended, because there were suddenly more than a few properties in your price range on the market, so it's going to take some time.

Your partner begins to drain his savings to help pay the mortgage, but soon he tells you that he no longer can. Then you're on your own.

Your tenants move out, and you can't find new ones because the influx of new properties on the market is driving down market rentals. Soon you find you're being squeezed, too. So much so that it could affect your ability to pay your own mortgage.

Your rental house goes into foreclosure, and you lose the property.

Guess what? The foreclosing lender will do a little due diligence to make sure the loan application was on the up-and-up. One way it does that is to compare the income that you and your partner listed on your loan application with the tax returns that you filed with the IRS.

If the IRS shows that your partner made only $5,000 per month and not the $10,000 per month that he swore to, there's a problem here, and a big one. You and your partner can expect a lawsuit.

Loan fraud simply isn't worth it. If you don't have the income to buy a property, then you need to wait; nothing is worth spending time in jail for.

And that's not what creative financing is all about.

Creative financing takes legitimate lending rules and applies them to everyday situations. Creative financing can come from an individual, usually either you or the seller, or from an institution.

Creative Financing From an Individual

The most common type of financing from an individual is seller financing. You find a property you want to buy and have the seller carry the note. Fair enough. But there are some things that you and the seller need to understand.

From the seller's perspective, she may want to know why you're going for private financing instead of getting financing from your bank or mortgage company. In other words, "I'll finance you, but there must be a problem somewhere, so therefore I'm going to ask for a higher interest rate to offset whatever risk might be involved."

Often the problem may be credit issues, but other times it might simply be that you have income that your lender can't currently use to qualify you, meaning that you don't have a two-year history or meet some other traditional guideline. For instance, you might need rental income to qualify, yet you don't have the necessary two years of landlord experience under your belt.

The Multiple Listing Service, or MLS, will typically show homes that have seller financing as part of the package, so you or your Realtor can use homes with owner financing as part of the search criteria, along with other features such as number of bedrooms and price range.

Why do sellers offer financing and not just cash out of the whole deal? There can be a variety of reasons, but sometimes it's a way to get a good, solid return but still keep hold of an asset.

If someone can get an 8.00 percent return from an investment, that's not bad income, and not only does it come every month, but if the buyer doesn't pay, then the owner can take the house back via a foreclosure.

For instance, suppose a retired couple owns a home free and clear, but the stock market isn't doing all that well and their retirement funds are pulling in maybe 4 percent per year. With seller financing, they can get much more than that 4 percent from a willing buyer.

Note that seller financing will also mean higher than market interest rates. If you can go out and get 6.50 percent on the market, then you might expect to pay 8.00 to 8.50 percent to a seller. The seller knows that you might have a specific reason for wanting seller financing and that it's likely that you couldn't qualify under conventional terms. In return for that higher level of risk, the seller may ask for a higher rate.

Also be prepared to provide the seller with as much documentation as you might provide to a traditional lender, especially your credit report and your income verification. If your income is hard to verify, show the owner how you're getting paid and how he will get his money.

If there are credit issues, the seller may ask for a larger down payment and increase your interest rate, just as a traditional lender would.

It's up to you. If the property cash flows work out and you can get into the property on terms that you agree to, go ahead and buy the property, and get two years' landlord experience under your belt. If rates are still low, you can refinance the property once you have that experience.

The Seller Carries the Note

Another option for seller financing is to have the seller carry a second mortgage note behind a first mortgage acquired at your mortgage company. This can be a benefit if you want to put less than 20 percent down, yet still avoid private mortgage insurance, or PMI.

For instance, suppose you want to buy a nice fourplex for $300,000 with as little down as possible. You can't find a lender who will loan you 90 percent of the sales price, but you find one who will loan you 80 percent.

With a seller carry, you can put down 10 percent; then the seller carries a second note at 10 percent of the value, and the first lender issues a loan at 80 percent of the sales price.

Sales price	$300,000
First lien note	$240,000
Down payment	$ 30,000
Seller carry	$ 30,000

With this structure, you've put the minimum down and avoided PMI with a seller carry.

Wraparound

A wraparound, or "wrap," is a way for you to buy from the seller where you make the mortgage payment to the seller, and she then turns around and pays her mortgage company.

Your mortgage is "wrapped" around another one. Wraps are negotiated between you and the seller, and any terms you come up with, as long as you both agree to them, are valid.

One note of caution with a wrap: Most conventional loans require that the lender be notified of any change in title, meaning that the property has changed ownership. If this is the case, a wrap may not be your best choice.

Some people say, "Well, who would know?" as long as you make your payments to the seller and the seller continues to make payments to the original mortgage company. And that's a good question; as long as there are no missed payments or other issues with the property, then the original lender might not ever find out.

But it might. And if it does, any agreement you may have had with the seller will be void, and it's likely that you will lose any equity or ownership in the property whatsoever. Since from a title standpoint the property was never transferred to you, if the home goes into foreclosure, you'll lose whatever you put in. From the original lender's viewpoint, the home was never yours, so it is the original owner who is wrapping for you who gets the home taken away from him, and you get nothing.

Assumptions

You can also search for properties that have assumable mortgages, where you not only buy the property but also slide right into whatever mortgage is already on the house. There are two types of assumable mortgages, qualifying and nonqualifying.

Qualifying assumptions mean that, yes, the loan is assumable, but you have to qualify on your own, just as if you were applying for a new mortgage. Nonqualifying means that you don't have to qualify. You can have terrible credit or no job or some other detrimental credit factor. The house and the note are still yours.

The trouble with nonqualifying assumptions is that there simply aren't that many of them around any longer. FHA and VA loans used to have this nonqualifying feature built into them. The theory was that if a homeowner was having problems paying the mortgage, she could sell the home quickly and have someone else take over the payments, keeping the home out of foreclosure.

The VA stopped including a nonqualifying feature in 1988; the FHA had done so in 1974. Too many people with bad credit assumed these loans and didn't make the payments, starting the foreclosure process all over again.

Assuming that you do find an assumable nonqualifying loan, since the mortgage will be 20 to 30 years old, you'll probably have to come to the closing table with plenty of equity to pay the seller. A seller won't give up that kind of money, and there's no reason for him to do so.

Lease Option

A lease option, or "lease with option to buy," is a method of financing when there are some credit or down payment issues or some other problem that's keeping you from getting conventional financing, yet you still want to acquire the property.

With a lease option, you lease the property for a specific period of time, then buy the property for an agreed-upon price at the end of your lease period.

Say you find a house for $150,000 and you want a lease option. You and the seller agree that you will lease the house for $1,000 per month and will buy the home at $150,000 after one year. Your price is set in stone, and if you did your homework correctly and home prices in that area appreciate 10 percent, then one year from now you will have a $165,000 home that you contracted to buy for $150,000.

Some lease-purchase agreements use a portion of the $1,000 per month as part of a down payment when you buy the home after one year. While this is certainly legitimate, it is important to note that whatever part of that $1,000 goes toward the purchase must be over and above what market rents are for properties in that area.

If you want $100 to go toward the home and $900 purely for rent, your lender will want to verify that rent for similar properties in that area is in fact $900 per month and not $1,000. If market rent is in fact $1,000, not $900, and you want a $1,200 credit toward your down payment (12 months times $100), the lender won't give it to you.

The $100 per month will be considered part of the rent, and anything the seller credits you with will be considered a gift and the deal can't close with gifts.

To make sure you get properly credited, validate the market rent in your area, either by finding rentals in the newspaper or in listings or by hiring an appraiser to perform a rental survey for you, the best way to determine market rent in such a case.

Lease options are not going to be your best financing vehicle. This technique should be used only if you have no other way of acquiring the property and you have an exit strategy. In fact, the deal really, really has to make sense for you.

First, you'll be subletting the property to others. If you negotiate a purchase price and a rental amount that both is substantially equivalent to the market rent and also adds money above the market rent to go toward a down payment, then what rent will your tenants be paying? You need to have cash flow, right?

If your lease-option payments to the seller are $1,000, then your tenants will have to pay less than that. What seller would do that? Why not just charge the current tenants the market rent?

I mention lease options as a vehicle for real estate investment only because occasionally I see it written or posted somewhere that such a transaction is an easy way to "buy with no money down" or some such. There can be instances where a lease option makes sense, but those occasions are very, very rare.

Creative Financing From an Institution

Portfolio Lending

A portfolio loan is one that the lender keeps in house—in its portfolio. The lender does not intend to sell the loan on the secondary markets anywhere, anytime. Your retail bank offers such loans.

When lenders make loans, they have to conform to lending guidelines. They do so for one main reason, and that's to provide the lender with a level of liquidity, or options. Lenders can make money by selling loans to one another or to Fannie Mae or Freddie Mac, or they can sit back and collect the interest payments each and every month. Or they can do any combination of the two. But this desire for liquidity also means that there can be very few exceptions to the lending guidelines. If a loan requires that you have been self-employed for two years and prove it by providing tax returns, and you've been self-employed for only 18 months, then you probably have to wait. But not with a portfolio loan.

A portfolio loan is designed more for you and less to meet a particular lending guideline. Forget guidelines such as number of properties owned or when you can or cannot use rental income to qualify you.

To apply for a portfolio loan, you don't call up a bank and say, "Hey, I need one of those portfolio loans"; instead, you establish a relationship with your commercial banker. Go to the bank where you have your personal and business checking accounts and schedule an appointment with your banker.

The retail bank will not use an automated underwriting program, but instead will evaluate your overall scenario, just like lenders did in the olden days. Your credit will be reviewed, your income and assets will be verified, and perhaps you will even be asked for a couple of references from business associates.

Portfolio lending can sometimes be a little easier than conventional loans, as once you get your first loan placed, it's easier to get the next one. You've already gone through the approval process, and as long as nothing has changed, your banker will be more than happy to give you another portfolio loan.

That's what banks do: lend money. Portfolio loans are a bank's strong asset. They are constantly looking for projects to fund.

Portfolio loans also have features that might not fit your financing goals. They are often short term—perhaps a maximum of two to three years. Banks don't like to keep their money tied up for very long. They can't because their profits are interest-sensitive.

If you get a loan from your bank at 6.00 percent and one year later rates are at 8.00 percent, then the bank sees your loan as having a "loss" of 2.00 percent. It's red ink on the bank's balance sheet. That's why portfolio loans can have a very short shelf-life: to give banks some flexibility.

Portfolio loans will also be adjustable-rate mortgages. Your ARM index can change from month to month, and your payments will then change too. A common ARM index for a bank is the prime rate, or the rate banks can charge their best commercial customers. If you're not one of the bank's "top-shelf" customers, you will probably also have a margin of 1, 2, or even 3 percent added to the prime rate.

Portfolio loans also will require a minimum of 20 percent down in most cases. Once you've established yourself as a good bank customer and have all your accounts at that bank, this down payment requirement can be reduced, but it will not be eliminated.

Higher rates, a larger down payment, and shorter maturity—those are the negatives of portfolio loans. The positives are both speed and getting a loan that wouldn't be approved under conventional lending guidelines. It's nice to be able to call up your banker and say, "Hey, David, I need a couple of hundred thousand to buy some duplexes next week."

Equity Transfers

If you're property rich and cash poor, or if you simply don't want to tie up any of your cash to buy investment property, then look around at some of your current investments to see how much equity might be available to use to buy more property. The easiest and least expensive source of equity is your primary residence. Mortgage rates for owner-occupied properties are usually about 3/8 percent lower than those for investment properties, so examine your primary residence first; it's your cheapest source. And there are two distinct ways of converting that equity into cash: cash-out refinancings and home equity lines of credit, or HELOCs.

A cash-out refinancing entails refinancing your current mortgage while at the same time pulling out additional money that will go directly to you in the form of a check. The maximum cash-out refinancing for almost every loan is an 80 percent loan to value ratio, or 80 percent LTV.

But one note of caution: Pulling out cash up to the maximum will cost you, typically about another 1/4 point or more. If you cash out to 75 percent of the value instead, there will be no penalty.

Here's an example of a cash-out refinancing on a primary residence.

Value of home	$300,000
Current mortgage balance	$130,000
Closing costs	$ 3,000
75% LTV	$225,000

Now subtract the current mortgage balance and closing costs from the value (as determined by a new appraisal on the property), and the result is $92,000 cash out.

At 80 percent, the refinancing would look like this:

Value of home	$300,000
Current mortgage balance	$130,000
Closing costs	$ 3,000
80% LTV	$240,000

Cash out in this example would be $107,000.

If you borrowed 80 percent of the value instead of 75 percent, you would be hit with another 1/4 point in fees, or $562, which would be deducted from your loan proceeds. You paid $562 to get another $15,000. Expensive, but available.

There is no reason to borrow the maximum. If you don't need or want $92,000, but instead want only $50,000, then just borrow that. You're not required to borrow the maximum; you just can't exceed predetermined limits.

But don't do a cash-out refinancing if a refinancing isn't already in your picture. If you have a 7.00 percent rate and interest rates move to 6.00 percent, then it makes sense to refinance, and you can go ahead and pull out cash either for immediate use or to hold for a purchase sometime in the future.

Perhaps you find that you can save money by refinancing, pulling out some equity, and depositing it in an interest-bearing account while you look for the perfect duplex. Don't cash out unless you have another reason to refinance, because there are costs involved in a refinancing just as with any other purchase money mortgage.

A way to tap into your equity without refinancing is simply to get a HELOC. It's quicker and cheaper. A HELOC is a line of credit that is placed in a second, or subordinate, position to your current first mortgage. There are few, if any, closing costs for a HELOC, and normally fees are charged only if you don't use the credit during the course of a 12-month period. Even then the fees are nominal, perhaps a couple of hundred bucks.

There isn't a full-blown appraisal, either; the lender will typically make a value determination using an automated valuation service that looks at recorded sales in your neighborhood and compares them to your property, less any mortgage balance.

A HELOC is sort of like a checkbook. In fact, you'll get a checkbook with a HELOC, and when you need the funds, you simply write a check. Interest will accrue only if you actually use any of the money.

HELOCs are typically limited to 100 percent of the valuation of the property. They can be more or less than that depending upon the type of loan and other state-imposed restrictions, but for the most part, you can get a HELOC for 100 percent of the value of the property.

Unlike the previous example, you can now borrow more money, and it costs less than a cash-out refinance.

Value of home	$300,000
Current mortgage balance	$130,000
Closing costs	$ -0-
100% LTV	$170,000

The maximum HELOC available is $170,000.

A HELOC can be used over and over again. If you used $50,000 as a down payment on an investment property, then later sold another property, you can repay the $50,000 you borrowed and restore the full amount of your HELOC. It literally is a credit card on your house.

It's also adjustable, which means that the rate you pay on this money can rise and fall with market rates in general.

Another form of second mortgage is an equity second. Instead of there being a revolving line of credit as in a HELOC, the amount of the second mortgage is fixed and you get all the proceeds at the closing table.

An equity second, or a home equity loan, can have a fixed or adjustable rate, and as with all second loans, the rates will usually be a couple of percentage points higher than the rates on first mortgages are.

Equity seconds also have few closing costs. However, you begin paying interest on them immediately because you took money and deposited it in your bank account. Equity lending is available on any property you own; it's just that with your primary residence, it's cheaper. And you can have more than one equity loan if you have the properties to match.

If you have 10 houses and each of them has an equity loan of $10,000, you then have $100,000 available to you to buy still more property. Equity lending is probably the most convenient source to tap when buying real estate.

Securitizing Other Assets

A distant cousin of equity lending is a pledged asset mortgage, or PAM. A PAM securitizes other tradable assets, such as stock portfolios, retirement accounts, or other publicly traded items and is a loan that is guaranteed by those assets.

If you own $100,000 in stocks, you can get a PAM at, say, 50 percent of that amount, or at whatever terms you can agree upon with whoever is holding your stocks and investments for you.

This is a form of equity lending because you're getting a loan based upon the equity (value) you have built up in your portfolio.

Hard Money Lending

One final piece of creative financing is called *hard money*.

Hard money is really a bad moniker. It implies that you're getting your loan from loan sharks who will break your arm if you're one day late or who are interested only in foreclosing on your property.

The fact is, the term *hard money* has simply been around too long to make any changes in terminology, even though hard money lenders themselves try to distance themselves from it.

Hard money is probably best described as being in between borrowing from a bank and taking on a business partner. A partner might be willing to finance your deal, but would want half the profits, and a bank would finance you at prime rate plus maybe a point or two.

First, hard money is for cases where either the property or the person buying it doesn't exactly fit either the conventional or the portfolio mold.

Second, hard money is usually loaned out only for very short terms when compared to 30-year loans. Hard money loans are typically for three months to a year.

Hard money can sometimes be considered as a way to get someone out of a jam. A common instance would be a developer who is almost, but not quite, finished with his project and needs some more funds to finish out development.

The developer would get a hard money loan to finish out the project, then pay back the hard money loan when the project sold.

A hard money lender needs to see a true exit strategy. In other words, how will I (the hard money lender) get my money back?

Hard money deals also require a good solid equity position, usually at least 65 percent LTV but sometimes as low as 50 percent LTV.

These loans depend less on credit and more on the assets involved, and thus they require a solid equity position. You can have damaged credit and still qualify for a hard money loan; you can even have hard-to-prove income as well because the hard money lender is banking on the sale of the project.

It's this sale of your project that you have to make clear.

Hard money loans also close quickly, sometimes in a matter of days rather than weeks, but while they're quick, they're also a little pricey when it comes to interest rate—often 5 to 10 percent above the prime rate.

But that's okay because the loan is for such a short term. It's cheaper than other alternatives or no alternative at all.

Hard money lenders typically get their business by advertising or by making calls to local banks telling the bank that they'll take referrals of deals that the bank can't do. If there's enough equity in a property, there's really no situation where a deal can't be done.

Blanket Mortgage

A blanket mortgage, as the name implies, is one big loan that covers several properties. This type of mortgage is available at your retail or commercial bank.

Blanket mortgages will most often require 20 percent down and can carry either a fixed or a variable rate. They're cheaper because there's only one closing for, say, 10 properties, but you won't get the absolute lowest rates for these loans.

Blanket mortgages are designed to purchase several similar properties in a neighborhood or several units in a condominium project simultaneously at one fell swoop. Blanket loans help you acquire a multitude of properties with one note in a quick fashion.

With a blanket mortgage, it's important that you have a reconveyance clause, which allows you to sell one property at a time and still keep the original note. Some blanket mortgages won't allow for a partial conveyance, meaning that if you want to sell one unit, you'll have to either sell them all or find new financing. The benefit with a blanket is that it's simple and is usually used when you find a terrific opportunity and want to close quickly.

If you found 10 houses you wanted to buy, you'd traditionally have to have 10 separate closings, which could quite possibly drive you through the roof. With a blanket, you'd have one loan for 10 properties.

Blankets are considered to be commercial loans; therefore you can get a blanket loan at your retail or commercial bank.

1031 Exchange

You've no doubt heard the term "1031 exchange" with regard to investment real estate. It is called that because the "1031" is the section of the IRS tax code that deals with tax deferment.

A 1031 exchange isn't really a method to finance real estate but a way to transfer equity from one property to buy another, deferring income taxes on the sale of the property being sold.

Say you have a duplex that's worth $200,000 that you paid $100,000 for and you want to buy another duplex for $200,000. Instead of selling the duplex for $200,000 and getting taxed on the $100,000 gain, you instead find a like property to "swap" by exchanging your property from the one you wish to buy.

You can use a 1031 as your down payment should the equity in your current property not be enough to completely purchase the new one. Your $200,000 duplex for another $200,000 duplex would be a straightforward exchange. But if you wanted to buy a $300,000 duplex and needed to finance the remainder, you'd have to come up with the balance just like with any other real estate loan.

1031s entail several rules you need to follow, and you'll need counsel to help make sure you're complying with all the IRS guidelines regarding property exchanges. For instance, a 1031 swap must be for like properties. You can't swap a bed-and-breakfast for your duplex, for instance.

If you have the opportunity to take advantage of a 1031 exchange, make sure you explore this method of transferring gains to invest in still more investment real estate while deferring income taxes on those gains.

Appraisable Assets

You can sell anything that has a value in order to get funds for buying real estate and getting financing. And I'm not kidding.

Do you own gold coins? Do you have artwork? Do you have the finest baseball card collection this side of the Mississippi? If assets can be appraised by an independent third party, you can convert those assets to cash.

Lenders want to verify the source of the funds you use to close. If you need $15,000 to close, then the lender wants to make sure that your $15,000 belongs to you and not to someone else. You didn't borrow those funds from someone else who just might have a legal interest in or hidden lien on the property you're about to purchase.

This is why sudden deposits need to be verified, and if you sell assets for cash, those assets must be something that can have an unbiased value. But you must have the asset appraised before you sell it.

I recall a client in Austin, Texas, who wanted to buy a bed and breakfast and needed to come up with some additional cash for a down payment and cash reserves. He was a book editor, and he also collected rare books on the side.

He sold two of his books, but he first had them appraised by a bookseller, who graded the books; he had a bill of sale, a copy of the check from the buyer, and a copy of the deposit slip and bank statement showing the deposit.

The underwriter who reviewed the application was not, of course, that big a book collector and had no idea of the value of the books my client had sold. Heck, who would unless you were in the business, right?

The underwriter not only reviewed the appraisal stating the approximate value of the books my client sold, but also reviewed some listings I had provided that I had printed off from eBay auctions showing the very same book, its grade, and what it sold for.

You can't just show up at closing with a box of Liberty silver dollars or a stamp collection. But if you have anything that's appraisable by a third party that can be bought and sold in the open market, then you have an asset that you can use to buy a property.

Builder-Owned Mortgage Companies

While this is not exactly creative financing, there is definitely a twist, and there are some things you need to be on guard for when you are dealing with a builder-owned mortgage company. Of builders who build houses in new subdivisions, nearly every one has its own mortgage firm, or at least an affiliation with such a firm.

When you sign a contract, there will be a stipulation that you must apply to the builder's mortgage company. You don't necessarily have to use the builder's lender, but at a minimum you have to make an application with it.

So far so good, right? You can't have too many people bidding for your business, right?

There will be incentives for you to work with the builder's company, and those incentives are sometimes easy to identify and sometimes not so easy. For instance, suppose your builder will pay 2 points toward your closing fees if you use its lender. That's not bad. But you need to do your own homework before you sign on the dotted line.

A builder-owned mortgage company doesn't have a corner on the mortgage market. It gets its mortgage rates from the very same wholesale lenders that other brokers do, and the loan officers at that company get paid the very same way that others do.

If a builder offers you 2 points, that sounds like a good thing, but if you compare the quote from the builder's mortgage company with a quote from an outside lender, you'll often find it's a shell game.

I recently closed a loan for a client who bought a newly built rental from a developer who would pay her 2 points to go toward closing costs. The problem was that while the builder's mortgage company "credited" her with 2 points, it also charged 2 points for the same exact rate I could get her. When I pointed this out to the client, it was one of those "aha!" moments. She then confided in me that she had fallen for this the last time she had bought a house from the very same builder.

Don't assume that you're getting a better deal from the builder just because he's paying points or origination fees. You might find that the lender will charge you 2 points, then credit those same points, making the whole thing a wash.

Another thing to watch out for with a builder's mortgage company is the sales contract. Read it carefully, because some contracts have a clause that says something like, "If the builder's mortgage company finds you a mortgage loan and you don't take it, you'll forfeit your deposit."

Still another client of mine lived in Texas but was buying in the Washington, D.C., area. His contract had that language, and it turned out to be very harmful.

The buyer had to sell one of his properties to buy the new one, but his old property wasn't selling and he was approaching his closing date. In fact, his debt ratios with the old and new mortgages, plus his current primary mortgage, were so high that he couldn't qualify for conventional financing.

His ratios were nearly 100 percent, meaning that the total house payments added up to almost everything he made each month—before taxes and withholdings!

The buyer was going to pull out, but the builder reminded him of the clause in his contract. The builder's mortgage company did indeed have a loan approved for him; it was a no document loan, with no income, employment, or assets being used to approve him. He had excellent credit, but he still hadn't sold his other property.

And he was in trouble. Not only did the builder's mortgage company have him approved, but because his was a no doc loan, his interest rate was significantly higher than what he had originally wanted. He tried to decline the loan, but the builder said, "Fine, but according to the contract you signed, you'll lose your $10,000 deposit."

The buyer was between a rock and a very hard place. If he took the loan he couldn't afford and his property still hadn't sold, he could be foreclosed upon. If he didn't take the loan, he'd lose his $10,000.

I couldn't help him out because I wasn't licensed in the D.C. area, but I did call both the builder's mortgage company and the builder; they basically could have cared less.

The buyer eventually agreed to buy another property if he could find a buyer for the one he had originally agreed to purchase (another shell game), which gave him more time to sell his other rental. He reduced the price enough to sell it quickly and bought the new property from the builder, although he held his nose the whole time when he was signing the closing papers.

The final thing to look at is offers of free upgrades if you use the builder's mortgage company: "Use my mortgage company and I'll throw in an upgrade package that normally costs $20,000."

Again, sounds good. But why would a builder "give" you $20,000 to make only $2,000 on a mortgage loan? It doesn't make good business sense. When you're offered such an incentive, try to compare the true retail price of that incentive (you can always go down to Home Depot or Lowe's and get quotes on the very same thing) with what the builder is offering you.

It's simply hard to judge with upgrade packages. Just make certain you've compared other lenders and mortgage brokers before you take the plunge. I'm not saying all builders' mortgage companies are bad; they're not. It's just that comparing mortgage loans can be confusing enough without trying to account for upgrades.

You may never have a need for creative financing. But sometimes you may find that you've stumbled across a property that you want to invest in, yet your finances are not quite ready for conventional lending. The creative alternatives in this chapter are all legal and have all been used in the open market. If someone or some business entity approaches you with any type of financing strategy that is not listed in this book as legitimate, then beware.

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Epilogue

Making bad financing decisions can wipe out your profits and turn a good deal into a bad one. So can paying too much for closing costs or getting ripped off by a bad loan officer.

When you buy real estate as an investment, remember that you're the person who makes everything go—or not go. Realtors and loan officers get paid commissions when you close a deal. Attorneys make money from you, and so do appraisers and title insurance companies. Suddenly everyone is after your business, and this can be overwhelming. That's okay; they're trying to make money just like anyone else.

But remember that once your deal closes, all those people go back to doing every single day what you may do occasionally. Loan officers close loans every day, and Realtors sell houses every day. It's easy for them to overlook the fact that you're a person and not a transaction. Keep a cool head and remind yourself, while you're in the middle of being a real estate investor, that nobody gets paid unless you close your deal, on terms that make financial sense for you. Nobody. So make sure the financing works for you.

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Glossary

Abstract of title. A document used in certain parts of the country when determining whether there are any previous claims on the property in question. The abstract is a written record of the historical ownership of the property that helps to determine whether the property can in fact be transferred from one party to another without any previous claims.

Acceleration. Paying off a loan early, usually at the request or demand of the lender. This is usually specified by an acceleration clause within a loan document that states what must happen for a loan to have to be paid immediately, but it most usually applies when payments are late or missed or there has been a transfer of the property without the lender's permission.

Adjustable-rate mortgage. A loan program where the interest rate may change over the life of the loan. The rate is adjusted in accordance with terms that have been agreed upon by the lender and the borrower, but typically it will change only once or twice a year.

Amortization. The process by which a loan is fully paid off over a predetermined period of time through equal payments made at regular intervals; such a loan is sometimes called a "fully amortized loan." Amortization terms vary, but generally accepted terms run in 5-year increments from 10 to 40 years.

Appraisal. A report that helps to determine the market value of a property. This report can be prepared in various ways as required by a lender, from simply driving by the property in a car to a full-blown inspection complete with full-color photographs of the real estate. Appraisals compare similar homes in the area to substantiate the value of the property in question.

APR. Annual percentage rate. The cost of money borrowed, expressed as an annual rate. It is a useful consumer tool for comparing different lenders, but unfortunately, it often is not used correctly. The APR is useful only when the same exact loan type is being compared from one lender to another. It doesn't work as well when comparing different types of mortgage programs with different down payments, terms, and so on.

Assumable mortgage. A mortgage that lets buyers take over the terms of the loan along with the house being sold. Assumable loans may be fully qualifying or nonqualifying. With nonqualifying assumable loans, buyers can take over the loan without having to be qualified or otherwise evaluated by the original lender. With qualifying assumable loans, while buyers may assume the terms of the existing note, they must qualify all over again as if they were applying for a brand-new loan.

Balloon mortgage. A type of mortgage where the remaining balance must be paid in full at the end of a preset term. A 5-year balloon mortgage might be amortized over a 30-year period but have the remaining balance be due, in full, at the end of 5 years.

Banker. A lender that uses its own funds to lend money. Historically, these funds would have come from savings accounts from other customers of the same bank. But with the evolution of mortgage banking, that's the old way of doing business. Even though bankers use their own money, it may come from other sources, such as lines of credit, or from selling loans to other institutions.

Basis point. One one-hundredth of a percent. Thus, 25 basis points is 1/4 of a discount point, and 100 basis points is 1 discount point.

Bridge loan. A short-term loan that is used primarily to pull equity out of one property for a down payment on another. This loan is paid off when the original property is sold. Since these are short-term loans, sometimes for just a few weeks, only retail banks generally offer them. Usually the borrower doesn't make any monthly payments and pays off the loan only when the property is sold.

Brokers. Mortgage companies that arrange a home loan between a banker and a borrower, similar to the way an independent insurance agent operates. Brokers don't have money to lend directly, but they have experience in finding various loan programs that can suit the borrower. Brokers don't work for the borrower, but instead provide mortgage loan choices from other mortgage lenders.

Bundling. The act of putting together several real estate or mortgage services in one package. Instead of paying for an appraisal here and an inspection there, some or all of the buyer's services are packaged together. Usually this allows the service provider to offer discounts on all services, although when the services are bundled, it's hard to look at all of them to see whether you're getting a good deal or not.

Buydown. Paying more money to get a lower interest rate. This is called a permanent buydown, and it is used in conjunction with discount points—the more points, the lower the rate. A temporary buydown is a fixed-rate mortgage that starts at a reduced rate for the first period, and then gradually increases to its final note rate. A temporary buydown for two years is called a 2–1 buydown. A buydown for three years is called a 3–2–1 buydown.

Cash out. Taking equity out of a home in the form of cash during a refinancing. Instead of just reducing your interest rate during a refinancing and financing your closing costs, you finance even more, putting the money in your pocket.

Certificate of Eligibility. The VA form that tells you and your VA lender both if you have VA entitlement available to use to buy or refinance using a VA loan, and if so, how much. It is required on every VA mortgage.

Closing costs. The various fees involved when buying a home or obtaining a mortgage. The fees can come directly from the lender or from others in the transactions whose participation is required if a good loan is to be issued.

Collateral. Property owned by the borrower that is pledged to the lender in case the loan goes bad. A lender makes a mortgage with the house as collateral.

Comparable sales. The part of an appraisal report that lists recent transfers of similar properties in the immediate area of the house being bought. Also called "comps."

Conforming loan. A Fannie Mae or Freddie Mac loan that is equal to or less than the maximum allowable loan limits established by Fannie Mae and Freddie Mac. These limits are changed annually.

Conventional loan. A mortgage using guidelines established by Fannie Mae or Freddie Mac and issued and guaranteed by a lender.

Credit report. A report showing a consumer's payment history along with the consumer's property addresses and any public records.

DD-214. The number of the VA form number that shows your discharge information from the armed services.

Debt consolidation. Paying off all or part of one's consumer debt with equity from a home. This can be part of a refinanced mortgage or a separate equity loan.

Debt ratio. Gross monthly payments divided by gross monthly income, expressed as a percentage. There are typically two debt ratios to be considered: The housing ratio (sometimes called the front ratio) uses the total monthly house payment plus any monthly tax, insurance, PMI, or Homeowners' Association dues divided by gross monthly income, and the total debt ratio (also called the back ratio) uses is the total housing payment plus other monthly consumer installment or revolving debt. Loan debt ratio guidelines are usually denoted as 32/38, with 32 being the front ratio and 38 being the back ratio. Ratio guidelines can vary from loan to loan and from lender to lender.

Deed. A written document evidencing each transfer of ownership in a property.

Deed of trust. A written document giving an interest in the home being bought to a third party, usually the lender, as security.

Delinquent. Being behind on a mortgage payment. Delinquencies are typically recognized as 30+ days delinquent, 60+ days delinquent, and 90+ days delinquent.

Discount points. Percentages of a loan amount; 1 discount point equals 1 percent of a loan balance. Borrowers pay discount points to reduce the interest rate on a mortgage, typically lowering the interest rate by 1/4 percent for each discount point paid. This is a form of prepaid interest to a lender. Also called "points."

Document stamp. Evidence—usually with a literal ink stamp—of how much tax was paid upon transfer of ownership of property. Called a "doc stamp" in certain states. Doc stamp tax rates can vary based upon locale. Some states don't have doc stamps; others do.

Down payment. The amount of money initially given by the borrower to close a mortgage; it equals the sales price less financing. It's the very first bit of equity you'll have in the home.

Easement. A right of way previously established by a third party. Easement types can vary, but they typically involve the right of a public utility to cross your land—for example, to access an electrical line.

Equity. The difference between the appraised value of a home and any outstanding loans recorded against the property.

Escrow. A term with two meanings, depending upon where you live. On the West Coast, there are escrow agents whose job it is to oversee the closing of a home loan. In other parts of the country, an escrow is a financial account set up by a lender to collect monthly installments for annual tax bills and/or hazard insurance policy renewals.

Escrow agent. On the West Coast, the person or company that handles the home closing, ensuring that documents are signed correctly and that the property transfer has taken place legitimately.

Fannie Mae. Federal National Mortgage Association. Originally established in 1938 by the U.S. government to buy FHA mortgages and provide liquidity in the mortgage marketplace. Its charter was changed in 1968, and it now purchases conventional mortgages as well as government ones.

Fed. The Federal Reserve Board. Among other things, the Fed sets overnight lending rates for banking institutions. It doesn't set mortgage rates.

Fee income. Closing costs received by a lender or broker other than interest or discount points. Fee income can be in the form of loan processing charges, underwriting fees, or other such assessments.

FHA. Federal Housing Agency. Formed in 1934 and now a division of the Department of Housing and Urban Development (HUD), it provides loan guarantees to lenders who make loans following FHA guidelines.

Final inspection. The last inspection of a property, showing that a new home that is being built is 100 percent complete or that a home improvement is 100 percent complete. This lets the lender know that its collateral and its loan are exactly where they should be.

Fixed-rate mortgage. A mortgage whose interest rate does not change throughout the term of the loan.

Float. An active decision not to "lock" or guarantee an interest rate while a loan is being processed. This is usually done because the borrower believes that rates will go down.

Float down. A mortgage loan rate that can drop as mortgage rates drop. There are usually two types of float, one being used during the construction of a home and the other during the period of an interest-rate lock.

Foreclosure. The bad thing that happens when the mortgage isn't repaid. Lenders begin the process of forcefully recovering their collateral when borrowers fail to make loan payments. The lender takes your house away.

Freddie Mac. Federal Home Loan Mortgage Corporation (FHLMC). A corporation established by the U.S. government in 1968 to buy mortgages made under Freddie Mac guidelines from lenders. Similar in structure to Fannie Mae.

Fully indexed rate. The number reached when a loan's index and its margin are added together. This is how the rate on an adjustable-rate note is determined.

Funding. The actual transfer of money from a lender to a borrower.

Gift. When buying a home, a situation in which the down payment and closing costs come from someone other than the borrower instead of coming from the borrower's own accounts. Usually such gifts can come only from family members or from foundations established to help new homeowners.

Ginnie Mae. Government National Mortgage Association (GNMA). A government corporation formed by the U.S. government to purchase government loans like VA and FHA loans from banks and mortgage lenders. Think of it as Fannie Mae or Freddie Mac, only it buys government loans.

Good Faith Estimate. A list of estimated closing costs on a particular mortgage transaction. This estimate must be provided to the loan applicant within 72 hours after the receipt of a mortgage application by the lender or broker.

Hazard insurance. A specific type of insurance that covers homeowners against certain destructive elements, such as fire, wind, and hail. It is usually an addition to homeowner's insurance, but every home loan has a hazard rider.

HELOC. Home equity line of credit. A credit line using a home as collateral. The customer writes a check on the line whenever he needs it and pays only on balances withdrawn. It's much like a credit card, but secured by the property.

Homeowner's insurance. An insurance policy covering not just hazard items but also other things such as liability and personal property.

Impound accounts. Accounts set up by a lender to receive the monthly portion of annual property taxes or hazard insurance. As taxes or insurance comes up for renewal, the lender pays the bill using these funds. Also called "escrow accounts."

Index. The basis for establishing an interest rate, usually with a margin added. Almost anything can be used as an index, but that most common are U.S. Treasuries or similar instruments. See *fully indexed rate.*

Inspection. A structural review of the house that looks for defects in workmanship, damage to the property, or required maintenance. An inspection does not determine the value of the property. A pest inspection looks for infestation by insects such as termites or wood ants.

Intangible tax. A state tax levied on personal property. An intangible asset is an asset not in itself but because of what it represents. A publicly traded stock is an intangible asset. It's not the stock itself that has the value, but what the stock represents in terms of ownership.

Interest rate. The amount charged to borrow money over a specified period of time.

Jumbo loan. A mortgage that exceeds current conforming loan limits.

Junior lien. A second mortgage or one that is subordinate to another loan. This term is not as common as it used to be. You're likely to hear simply "second mortgage" or "piggyback."

Land contract. An arrangement in which the buyer makes monthly payments to the seller, but the ownership of the property does not change hands until the loan is paid in full. This is similar to the way an automobile loan works: When you pay off the loan, you get title to the car.

Land to value. An appraisal term that calculates the value of the land as a percentage of the total value of the home. If the value of the land exceeds the value of the home, it's more difficult to find financing without good comparable sales. Also called lot to value.

Lender policy. Title insurance that protects a mortgagee from defects or previous claims of ownership.

Liability. An obligation of the borrower. Liabilities can be things that show up on a credit report, such as student loans or car payments, but they can also be anything else that one is obligated to pay. It's the ones on the credit report that are used to determine debt ratios.

Loan. Money granted to one party with the expectation of its being repaid.

Loan officer. The person typically responsible for helping mortgage applicants get qualified; she assists in loan selection and loan application. Loan officers can work at banks, credit unions, or mortgage brokerage houses or for bankers.

Loan processor. The person who gathers the documentation required for submission of a loan application. Along with your loan officer, you'll work with this person quite a bit during your mortgage process.

Lock. The act of guaranteeing an interest rate for a predetermined period of time. Loan locks are not loan approvals; they're simply the rate your lender has agreed to give you at the loan closing.

Margin. A number, expressed as a percentage, that is added to a mortgage's index to determine the rate the borrower pays on the note. For example, suppose the index is a six-month CD at 4.00 percent and the margin is 2.00 percent. The interest rate that the borrower pays is 4 + 2, or 6.00 percent. A fully indexed rate is the index plus the margin.

Market value. In an open market, the value of a property that is both the most that the buyer was willing to pay and the least that the seller was willing to accept at the time of contract. Property appraisals help justify market value by comparing similar home sales in the subject property's neighborhood.

Mortgage. A loan on property where the property is pledged as collateral. The mortgage is retired when the loan is paid in full.

Mortgage-backed securities. Investment securities issued by Wall Street firms that are guaranteed, or collateralized, by home mortgages taken out by consumers. These securities can then be bought and sold on Wall Street.

Mortgage insurance (MI). An insurance policy, paid by the borrower with benefits paid to the lender, that covers the difference between the borrower's down payment and 20 percent of the sales price. If the borrower defaults on the mortgage, this difference is paid to the lender. MI, also called "private mortgage insurance" (PMI), is typically required on all mortgage loans with less than 20 percent down.

Mortgagee. The person or business making the loan.

Mortgagor. The person(s) getting the loan; the borrower.

Multiple Listing Service (MLS). A central repository where real estate brokers and agents show homes and search for homes that are for sale.

Negative amortization (neg-am). An adjustable-rate mortgage that can have two interest rates, the contract rate or the fully indexed rate. The contract rate is the minimum agreed-upon rate that the consumer may pay; it is usually lower than the fully indexed rate. The borrower has a choice of which rate to pay, but if the contract rate is lower than the fully indexed rate, the difference between the two payments is added to the loan. If your contract payment is only $500 but the payment at the fully indexed rate is $700 and you pay only the contract rate, $200 is added to your original loan amount. This is not for the faint of heart or for those with little money down.

Nonconforming. A mortgage loan in an amount above the current Fannie Mae or Freddie Mac limits. Also called "jumbo mortgages."

Note. A promise to repay. There may or may not be property involved, and a note may or may not be a mortgage.

NOV. Notice of value. The VA name for your appraisal.

Origination fee. A fee charged to cover costs associated with finding, documenting, and preparing a mortgage application, usually expressed as a percentage of the loan amount.

Owner's policy. Title insurance for the benefit of the homeowner.

PITI. Principal, interest, taxes, and insurance. These figures are used to help determine front debt ratios.

PMI. Private mortgage insurance. See *mortgage insurance (MI)*.

Prepaid interest. Daily interest from the day of the loan closing to the first of the following month. Also can be in the form of a discount point.

Prepayment penalty. A monetary penalty paid to the lender if the loan is paid off before its maturity or if extra payments are made on the loan. Prepayment penalties are sometimes categorized as "hard" or "soft." A hard penalty is an automatic penalty if the loan is paid off early or if extra payments are made at any time or for any amount whatsoever. A soft penalty lasts for only a couple of years and may allow extra payments on the loan as long as they do not exceed a certain amount.

Principal. The outstanding amount owed on a loan, not including any interest due.

Points. See *discount points.*

Realtor. A member of the National Association of Realtors. This is a registered trademark; not all real estate agents are Realtors.

Refinancing. Obtaining a new mortgage to replace an existing one.

Sales contract. A written agreement, signed by both the seller and the buyer, to buy or sell a home.

Second mortgage. A mortgage that assumes a subordinate position behind a first mortgage. If the home goes into foreclosure, the first mortgage must be settled before the second can lay claim. Sometimes called a "piggyback" mortgage.

Secondary market. A financial arena where mortgages are bought and sold, either individually or grouped together into securities backed by those mortgages. Fannie Mae and Freddie Mac are the backbone of the conventional secondary market. Other secondary markets exist for nonconforming loans, subprime loans, and other types of loans.

Seller. The person transferring ownership of and all rights in your home in exchange for cash or other assets.

Settlement statement. A document that shows all financial entries during the home sale, including sales price, closing costs, loan amounts, and property taxes. Your initial Good Faith Estimate will be your first glimpse of your settlement statement. This statement is one of the final documents put together before you go to closing and is prepared by your attorney or settlement agent. Also called "Final HUD-1."

Survey. A map that shows the physical dimensions of any structures and where they sit on the property. It also indicates any easements that run across or through the property.

Title. Ownership in a property.

Title exam/title search. The process in which public records are reviewed to uncover any previous liens on the property.

Title insurance. An insurance policy that protects the lender, the seller, and/or the borrower against any defects in title for or previous claims to the property being transferred or sold.

Underwriter. The person who physically approves the loan, making sure that the loan meets lending guidelines, and signs off on the documentation submitted.

Verification of deposit (VOD). A written form sent by the lender to a financial institution to verify the amount of funds in an account. This form also shows how long the account has been open, everyone who has a claim to the account, and any deposits and withdrawals from or to the account.

Verification of employment (VOE). A written form sent by the lender to an employer to verify an applicant's employment. This form also shows how long the applicant has worked at her job, how much the applicant makes, and any recent raises or bonuses.

Yield spread premium (YSP). The difference in basis points from one rate to another offered by a wholesale lender in return for a higher rate. The opposite of discount points, which are paid to get a lower rate, YSPs are paid by the lender to get a higher rate. They are often used to offset borrowers' closing costs and to provide a no-points, no-fee mortgage loan.

Payment Tables

Payments per Thousand Dollars Financed

Find the interest rate, move across to the Term column, and multiply that number by the number of thousand dollars financed.

Example: 6.50 percent, 30-year term on $150,000

$6.32 × 150 (thousands) = $948.00 principal and interest payment

Rate	40 years	30 years	25 years
2.500	$3.30	$3.95	$4.49
2.625	$3.37	$4.02	$4.55
2.750	$3.44	$4.08	$4.61
2.875	$3.51	$4.15	$4.68
3.000	$3.58	$4.22	$4.74

3.125	$3.65	$4.28	$4.81
3.250	$3.73	$4.35	$4.87
3.375	$3.80	$4.42	$4.94
3.500	$3.87	$4.49	$5.01
3.625	$3.95	$4.56	$5.07
3.750	$4.03	$4.63	$5.14
3.875	$4.10	$4.70	$5.21
4.000	$4.18	$4.77	$5.28
4.125	$4.26	$4.85	$5.35
4.250	$4.34	$4.92	$5.42
4.375	$4.42	$4.99	$5.49
4.500	$4.50	$5.07	$5.56
4.625	$4.58	$5.14	$5.63
4.750	$4.66	$5.22	$5.70
4.875	$4.74	$5.29	$5.77
5.000	$4.82	$5.37	$5.85
5.125	$4.91	$5.44	$5.92
5.250	$4.99	$5.52	$5.99
5.375	$5.07	$5.60	$6.07
5.500	$5.16	$5.68	$6.14
5.625	$5.24	$5.76	$6.22
5.750	$5.33	$5.84	$6.29
5875	$5.42	$5.92	$6.37
6.000	$5.50	$6.00	$6.44
6.125	$5.59	$6.08	$6.52
6.250	$5.68	$6.16	$6.60
6.375	$5.77	$6.24	$6.67
6.500	$5.85	$6.32	$6.75
6.625	$5.94	$6.40	$6.83
6.750	$6.03	$6.49	$6.91
6.875	$6.12	$6.57	$6.99
7.000	$6.21	$6.65	$7.07
7.125	$6.31	$6.74	$7.15

7.250	$6.40	$6.82	$7.23
7.375	$6.49	$6.91	$7.31
7.500	$6.58	$6.99	$7.39
7.625	$6.67	$7.08	$7.47
7.750	$6.77	$7.16	$7.55
7.875	$6.86	$7.25	$7.64
8.000	$6.95	$7.34	$7.72
8.125	$7.05	$7.42	$7.80
8.250	$7.14	$7.51	$7.88
8.375	$7.24	$7.60	$7.97
8.500	$7.33	$7.69	$8.05
8.625	$7.43	$7.78	$8.14
8.750	$7.52	$7.87	$8.22
8.875	$7.62	$7.96	$8.31
9.000	$7.71	$8.05	$8.39
9.125	$7.81	$8.14	$8.48
9.250	$7.91	$8.23	$8.56
9.375	$8.00	$8.32	$8.65
9.500	$8.10	$8.41	$8.74
9.625	$8.20	$8.50	$8.82
9.750	$8.30	$8.59	$8.91
9.875	$8.39	$8.68	$9.00
10.000	$8.49	$8.78	$9.09
10.125	$8.59	$8.87	$9.18
10.250	$8.69	$8.96	$9.26
10.375	$8.79	$9.05	$9.35
10.500	$8.89	$9.15	$9.44
10.625	$8.98	$9.24	$9.53
10.750	$9.08	$9.33	$9.62
10.875	$9.18	$9.43	$9.71
11.000	$9.28	$9.52	$9.80
11.125	$9.38	$9.62	$9.89
11.250	$9.48	$9.71	$9.98

11.375	$9.58	$9.81	$10.07
11.500	$9.68	$9.90	$10.16
11.625	$9.78	$10.00	$10.26
11.750	$9.88	$10.09	$10.35
11.875	$9.98	$10.19	$10.44
12.000	$10.08	$10.29	$10.53
12.125	$10.19	$10.38	$10.62
12.250	$10.29	$10.48	$10.72
12.375	$10.39	$10.58	$10.81
12.500	$10.49	$10.67	$10.90
12.625	$10.59	$10.77	$11.00
12.750	$10.69	$10.87	$11.09
12.875	$10.79	$10.96	$11.18
13.000	$10.90	$11.06	$11.28
13.125	$11.00	$11.16	$11.37
13.250	$11.10	$11.26	$11.47
13.375	$11.20	$11.36	$11.56
13.500	$11.30	$11.45	$11.66
13.625	$11.40	$11.55	$11.75
13.750	$11.51	$11.65	$11.85
13.875	$11.61	$11.75	$11.94
14.000	$11.71	$11.85	$12.04
14.125	$11.81	$11.95	$12.13
14.250	$11.92	$12.05	$12.23
14.375	$12.02	$12.15	$12.33
14.500	$12.12	$12.25	$12.42
14.625	$12.22	$12.35	$12.52
14.750	$12.33	$12.44	$12.61
14.875	$12.43	$12.54	$12.71
15.000	$12.53	$12.64	$12.81
15.125	$12.64	$12.74	$12.91
15.250	$12.74	$12.84	$13.00
15.375	$12.84	$12.94	$13.10

15.500	$12.94	$13.05	$13.20
15.625	$13.05	$13.15	$13.30
15.750	$13.15	$13.25	$13.39
15.875	$13.25	$13.35	$13.49
16.000	$13.36	$13.45	$13.59
16.125	$13.46	$13.55	$13.69
16.250	$13.56	$13.65	$13.79
16.375	$13.67	$13.75	$13.88
16.500	$13.77	$13.85	$13.98
16.625	$13.87	$13.95	$14.08
16.750	$13.98	$14.05	$14.18
16.875	$14.08	$14.16	$14.28
17.000	$14.18	$14.26	$14.38
17.125	$14.29	$14.36	$14.48
17.250	$14.39	$14.46	$14.58
17.375	$14.49	$14.56	$14.68
17.500	$14.60	$14.66	$14.78
17.625	$14.70	$14.77	$14.87
17.750	$14.80	$14.87	$14.97
17.875	$14.91	$14.97	$15.07
18.000	$15.01	$15.07	$15.17

Rate	20 years	15 years	10 years
2.500	$5.30	$6.67	$9.43
2.62	5$5.36	$6.73	$9.48
2.750	$5.42	$6.79	$9.54
2.875	$5.48	$6.85	$9.60
3.000	$5.55	$6.91	$9.66
3.125	$5.61	$6.97	$9.71
3.250	$5.67	$7.03	$9.77
3.375	$5.74	$7.09	$9.83

3.500	$5.80	$7.15	$9.89
3.625	$5.86	$7.21	$9.95
3.750	$5.93	$7.27	$10.01
3.875	$5.99	$7.33	$10.07
4.000	$6.06	$7.40	$10.12
4.125	$6.13	$7.46	$10.18
4.250	$6.19	$7.52	$10.24
4.375	$6.26	$7.59	$10.30
4.500	$6.33	$7.65	$10.36
4.625	$6.39	$7.71	$10.42
4.750	$6.46	$7.78	$10.48
4.875	$6.53	$7.84	$10.55
5.000	$6.60	$7.91	$10.61
5.125	$6.67	$7.97	$10.67
5.250	$6.74	$8.04	$10.73
5.375	$6.81	$8.10	$10.79
5.500	$6.88	$8.17	$10.85
5.625	$6.95	$8.24	$10.91
5.750	$7.02	$8.30	$10.98
5.875	$7.09	$8.37	$11.04
6.000	$7.16	$8.44	$11.10
6.125	$7.24	$8.51	$11.16
6.250	$7.31	$8.57	$11.23
6.375	$7.38	$8.64	$11.29
6.500	$7.46	$8.71	$11.35
6.625	$7.53	$8.78	$11.42
6.750	$7.60	$8.85	$11.48
6.875	$7.68	$8.92	$11.55
7.000	$7.75	$8.99	$11.61
7.125	$7.83	$9.06	$11.68
7.250	$7.90	$9.13	$11.74
7.375	$7.98	$9.20	$11.81
7.500	$8.06	$9.27	$11.87

7.625	$8.13	$9.34	$11.94
7.750	$8.21	$9.41	$12.00
7.875	$8.29	$9.48	$12.07
8.000	$8.36	$9.56	$12.13
8.125	$8.44	$9.63	$12.20
8.250	$8.52	$9.70	$12.27
8.375	$8.60	$9.77	$12.33
8.500	$8.68	$9.85	$12.40
8.625	$8.76	$9.92	$12.47
8.750	$8.84	$9.99	$12.53
8.875	$8.92	$10.07	$12.60
9.000	$9.00	$10.14	$12.67
9.125	$9.08	$10.22	$12.74
9.250	$9.16	$10.29	$12.80
9.375	$9.24	$10.37	$12.87
9.500	$9.32	$10.44	$12.94
9.625	$9.40	$10.52	$13.01
9.750	$9.49	$10.59	$13.08
9.875	$9.57	$10.67	$13.15
10.000	$9.65	$10.75	$13.22
10.125	$9.73	$10.82	$13.28
10.250	$9.82	$10.90	$13.35
10.375	$9.90	$10.98	$13.42
10.500	$9.98	$11.05	$13.49
10.625	$10.07	$11.13	$13.56
10.750	$10.15	$11.21	$13.63
10.875	$10.24	$11.29	$13.70
11.000	$10.32	$11.37	$13.78
11.125	$10.41	$11.44	$13.85
11.250	$10.49	$11.52	$13.92
11.375	$10.58	$11.60	$13.99
11.500	$10.66	$11.68	$14.06
11.625	$10.75	$11.76	$14.13

11.750	$10.84	$11.84	$14.20
11.875	$10.92	$11.92	$14.27
12.000	$11.01	$12.00	$14.35
12.125	$11.10	$12.08	$14.42
12.250	$11.19	$12.16	$14.49
12.375	$11.27	$12.24	$14.56
12.500	$11.36	$12.33	$14.64
12.625	$11.45	$12.41	$14.71
12.750	$11.54	$12.49	$14.78
12.875	$11.63	$12.57	$14.86
13.000	$11.72	$12.65	$14.93
13.125	$11.80	$12.73	$15.00
13.250	$11.89	$12.82	$15.08
13.375	$11.98	$12.90	$15.15
13.500	$12.07	$12.98	$15.23
13.625	$12.16	$13.07	$15.30
13.750	$12.25	$13.15	$15.38
13.875	$12.34	$13.23	$15.45
14.000	$12.44	$13.32	$15.53
14.125	$12.53	$13.40	$15.60
14.250	$12.62	$13.49	$15.68
14.375	$12.71	$13.57	$15.75
14.500	$12.80	$13.66	$15.83
14.625	$12.89	$13.74	$15.90
14.750	$12.98	$13.83	$15.98
14.875	$13.08	$13.91	$16.06
15.000	$13.17	$14.00	$16.13
15.125	$13.26	$14.08	$16.21
15.250	$13.35	$14.17	$16.29
15.375	$13.45	$14.25	$16.36
15.500	$13.54	$14.34	$16.44
15.625	$13.63	$14.43	$16.52
15.750	$13.73	$14.51	$16.60

15.875	$13.82	$14.60	$16.67
16.000	$13.91	$14.69	$16.75
16.125	$14.01	$14.77	$16.83
16.250	$14.10	$14.86	$16.91
16.375	$14.19	$14.95	$16.99
16.500	$14.29	$15.04	$17.06
16.625	$14.38	$15.13	$17.14
16.750	$14.48	$15.21	$17.22
16.875	$14.57	$15.30	$17.30
17.000	$14.67	$15.39	$17.38
17.125	$14.76	$15.48	$17.46
17.250	$14.86	$15.57	$17.54
17.375	$14.95	$15.66	$17.62
17.500	$15.05	$15.75	$17.70
17.625	$15.15	$15.84	$17.78
17.750	$15.24	$15.92	$17.86
17.875	$15.34	$16.01	$17.94
18.000	$15.43	$16.10	$18.02

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