Making Everything Easier!™

Financing Real Estate Investments

FOR DUMMIES®

Learn to:

- Evaluate potential lenders
- Maximize your cash flow
- Finance through private lenders
- Tap into government programs

Ralph R. Roberts
Real estate professional and coauthor of Foreclosure Investing For Dummies

Chip Cummings
Real estate financing expert and author

Financing Real Estate Investments FOR DUMMIES®

by Ralph R. Roberts and
Chip Cummings with Joe Kraynak

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To learn more about Chip Cummings, his many successful products or how he can help your organization as a speaker or business consultant, visit `www.ChipCummings.com`. To receive a complimentary subscription to his multimedia e-newsletter and online events, check out `www.eCoachingClub.com`. You can also reach Chip by emailing him at `info@ChipCummings.com` or by calling 616-977-7900.

Joe Kraynak (`joekraynak.com`) is a freelance author who has written and coauthored numerous books on topics ranging from slam poetry to computer basics. Joe teamed up with Dr. Candida Fink to write his first book in the *For Dummies* series, *Bipolar Disorder For Dummies,* where he showcased his talent for translating the complexities of a topic into plain-spoken practical advice. He then teamed up with Roberts to write the ultimate guide to flipping houses — *Flipping Houses For Dummies* and delivered encore performances in *Foreclosure Investing For Dummies*, *Advanced Selling For Dummies*, and *Foreclosure Self-Defense For Dummies*. In *Financing Real Estate Investments For Dummies,* Joe assists Chip and Ralph in delivering the ultimate guide to scoring some cash to fuel your investments in real estate.

Dedication

From Ralph: To real estate investors and professionals who are dedicated to supporting and promoting the American dream of homeownership.

From Chip: To my assistant Debbie Forth who has managed to keep me organized for the last 14 years, and to my wife Lisa who puts up with all the crazy hours and remains my #1 fan.

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Introduction

Real estate investing is an expensive habit. You need money to finance the purchase, renovate your fixer-upper, and cover the holding costs while you prepare to sell or rent the property. The good news is that it doesn't all have to be *your* money. In fact, the less of your own money you can use and the more you can borrow, the bigger the return on your investment. Add the potential credit and market woes like the first decade of the 2000s, and investing in real estate also becomes a bit more of an adventure.

Lining up financial resources well in advance of scouring the neighborhood for investment opportunities enables you to pounce on a bargain and gives you leverage in negotiating the price you ultimately pay for a property. When you place an offer on a house and other bids come in, the seller may accept your offer of thousands of dollars less simply because you have the financing in place to quickly close the deal. Ready cash also frees you to plan and begin rehabbing the property immediately instead of waiting around for sluggish loan approvals and credit checks.

If you're thinking that you can't possibly get your mitts on enough cash to finance your venture, *Financing Real Estate Investments For Dummies* is the book for you. Here you discover the best sources for investment capital and how to go about tapping into these sources to fuel your next venture.

About This Book

This book isn't a get-rich-quick guide to investing in real estate or a guide or a tutorial on how to buy property with no money down (although we do cover that topic). *Financing Real Estate Investments For Dummies* delivers what the title promises — a treasure map that shows you where to find sources of real estate investment capital and guidance on how to dig it up.

Ralph and Chip are both seasoned investors. We've each built wealth through investing in real estate — buying and selling fixer-uppers and buying and renting out both residential and commercial property. Although we have used our own money on occasion to finance our purchases and renovations, we've primarily succeeded with the use of other people's money (OPM). Our grandmothers were our first financial backers, but we've expanded our options since then.

We have more than 50 years' worth of combined experience in buying and selling real estate and securing the financing to do it. In this book, we share what we know with you, showing you how to tap into loans from banks; mortgage companies; private lenders; federal, state, and local government programs; and more. In the process we cover financing for both residential and commercial properties.

Conventions Used in This Book

Compared to other books on financing real estate investments, *Financing Real Estate Investments For Dummies* is anything but conventional, but we do use some conventions to call your attention to certain items. For example:

- *Italics* highlight new, somewhat technical terms, such as *hard money,* and emphasize words when we're driving home a point.
- **Boldface** text indicates key words in bulleted and numbered lists.
- `Monofont` highlights Web addresses.

Financing the purchase and renovation of residential properties, such as homes, is quite different from financing the purchase and renovation of commercial properties. You deal with different lenders who use different methods for evaluating your loan application and the property you're planning to buy.

In this book, we cover both types of financing, but you should know up front the differences between residential and commercial property:

- **Residential:** One- to four-family dwellings classify as residential properties, which qualify for residential financing.
- **Commercial:** Properties used to conduct business and any rental properties designed to house more than four families qualify as commercial real estate. Loan approval for these properties hinges more on the property's potential for generating sufficient income to make the payments than on the borrower's financial strength.

In addition, even though you see three author names on the cover of this book — Chip, Ralph, and Joe — the "we" is usually Chip and Ralph talking. Joe is the wordsmith — the guy responsible for keeping you engaged and entertained and making sure *we* explain everything as clearly and thoroughly as possible.

What You're Not to Read

Although we encourage you to read this book from cover to cover to maximize the return on your investment, we realize that in today's busy world you may have time to read only the information pertinent to your situation. If so, you can safely skip anything you see in a gray shaded box. We stuck this material in a box for the same reason that most people stick stuff in boxes — to get it out of the way, so you wouldn't trip over it. However, you may find the stories and brief asides uproariously funny and perhaps even mildly informative (or vice versa).

Foolish Assumptions

We assume you already mastered the basics of investing in real estate. If you haven't, we encourage you to pick up a copy of either (or both) *Real Estate Investing For Dummies,* 2nd Edition, by Eric Tyson and Robert S. Griswold, or *Commercial Real Estate Investing For Dummies* by Peter Conti and Peter Harris (Wiley).

If you're interested in flipping houses or focusing on foreclosure properties, check out *Flipping Houses For Dummies* or *Foreclosure Investing For Dummies* by Ralph R. Roberts with Joe Kraynak. If you're thinking of becoming a landlord, we strongly encourage you to first read *Property Management For Dummies* by Robert S. Griswold. Not everyone has the right stuff to be a landlord, but if you know what you're getting into before you take on the role, you can significantly improve your survival odds.

How This Book Is Organized

Financing Real Estate Investments For Dummies facilitates a skip-and-dip approach. It presents the information in easily digestible chunks, so you can skip to the chapter or section that grabs your attention or meets your current needs, master it, and then skip to another section or simply set the book aside for later reference.

To help you navigate, we took the 17 chapters that make up the book and divvied them up into five parts. Here, we provide a quick overview of what we cover in each part.

Part I: Gearing Up for Financing Your Real Estate Investments

When you become a real estate investor, you're essentially building a business; you should build it on a strong foundation. In this part, we cover the basics, providing you with definitions of standard terminology and concepts you're likely to encounter, introducing you to the various sources of investment capital, showing you how to protect yourself against potential risks, and leading you through the process of gathering all the documents and other information you need to apply for financing.

In the process, we reveal the power of using OPM to gain leverage and expose your own money and other assets to less risk.

Part II: Financing the Purchase of Residential Properties

In this part, we explore the many residential loan programs currently available, show you how to compare different loan packages to find the one that costs the least overall, and lead you through the loan application process from filling out the forms to closing.

By the end of this part, you should have the financing you need to start hunting for residential real estate investment opportunities.

Part III: Financing the Purchase of Commercial Properties

In this part, we introduce you to the most common commercial property types, so you can choose the type best suited to your investment goals and evaluate the properties based on their potential for generating a positive cash flow. We take you on a tour of some of the unique sources of financing available for commercial ventures. Finally, we step you through the process of applying for commercial real estate loans from application to closing.

Part IV: Sampling More Creative Financing Strategies

In this part, you discover the pros and cons of *hard money* — cash that's generally easier but more expensive to borrow for purchasing investment properties. We also show you how to finance the purchase through the seller by purchasing properties on contract, how to partner with an investor who's cash heavy, and how to track down no-money-down deals.

These options aren't for everybody, but when you're in the market for investment properties and can't get your hands on conventional financing, these unconventional sources can be a deal saver.

Part V: The Part of Tens

The Part of Tens is the highlight of every *For Dummies* title, offering quick strategies, tips, and insights on whatever subject the book covers. The chapters in this Part of Tens reveal how to avoid the ten most common mistakes when financing real estate investments, which questions you should ask prospective lenders, ten steps to take to prepare for your next closing, and ten strategies for surviving a credit crunch.

Icons Used in This Book

Throughout this book, we sprinkle icons in the margins to cue you in on different types of information that call out for your attention. Here are the icons you'll see and a brief description of each.

We want you to remember everything you read in this book, but if you can't quite do that, be sure to remember the important points flagged with this icon.

Tips provide insider insight from behind the scenes. When you're looking for a better, faster, cheaper way to do something, check out these tips.

"Whoa!" This icon appears when you need to be extra vigilant or seek professional help before moving forward.

Where to Go From Here

Financing Real Estate Investments For Dummies is sort of like an information kiosk. You can start with the chapters in Part I to master the basics and then skip to Part II if you're planning on financing the purchase of residential property or Part III if your focus is more on commercial properties.

For a quick primer on financing the purchase of real estate investments, check out Chapter 1. Chapter 4 is a great place to start if you're not sure where to start looking for lenders — this chapter touches on everything from banks and mortgage companies to private lenders and partnering with others who have cash.

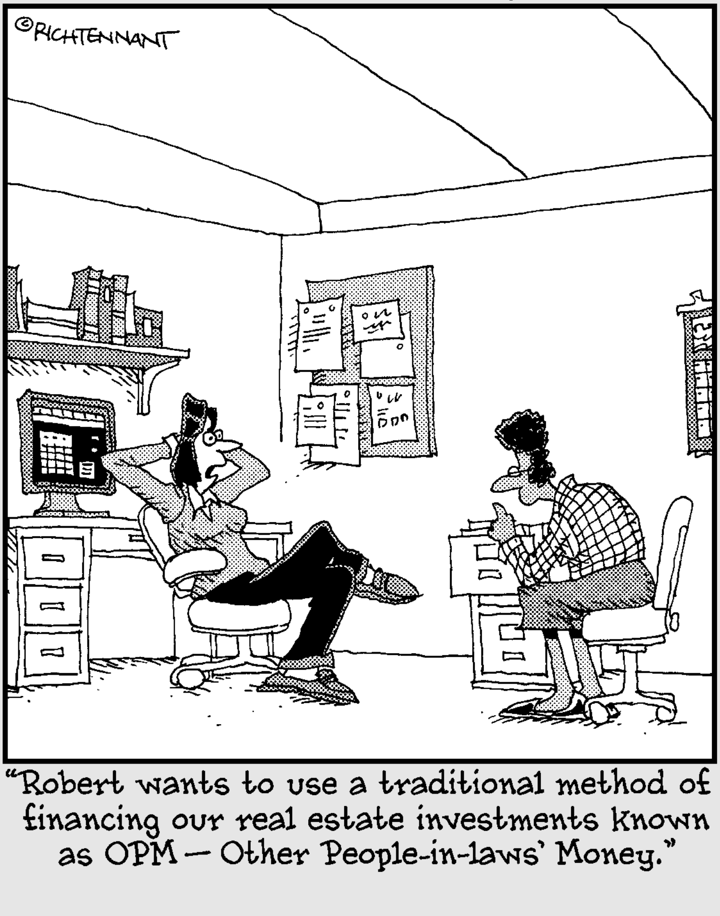
We do consider Chapter 6 required reading. All too often investors get burned because they focus too much on interest rates and not on other factors contributing to the overall cost of borrowing money. This chapter offers a quick way to compare two loans side-by-side to determine which one costs less over the life of the loan.

If you're planning to invest in commercial properties, Chapter 8 is also required reading. In this chapter, we show you how to evaluate different types of properties the way lenders do it when you apply for a loan.

If you're looking for information on a very specific topic, flip to the back of the book, where you can find a comprehensive index of key topics.

Part I
Gearing Up for Financing Your Real Estate Investments

The 5th Wave   By Rich Tennant



"Robert wants to use a traditional method of financing our real estate investments known as OPM — Other People-in-laws' Money."

In this part . . .

The key to scoring affordable financing and keeping a bigger chunk of your after-tax profits from real estate investments is preparation. By understanding the leverage you can gain using other people's money (OPM) to finance your investments and having all your financial records in place, you increase your odds of securing financing with attractive terms and interest rates.

By understanding tax laws and loopholes before you get started, you can lay the groundwork necessary to maximize your tax deductions and exclusions and keep more profit for yourself. And by understanding the differences between different types of lenders, you gain access to additional sources of investment capital you may never have considered.

In this part, we help you build your real estate investment venture on a firm foundation so you have ready access to cash while minimizing your exposure to risk.

Chapter 1

Taking a Crash Course in Real Estate Investment Financing

In This Chapter

- ▶ Gaining leverage with other people's money
- ▶ Deciphering key terms
- ▶ Grasping the difference between a home and investment property
- ▶ Discovering vital sources of real estate investment capital
- ▶ Getting ready to meet your lender

Are you eager to set out on the road to building wealth through real estate? Although we hate to hold you back, we do discourage you from moving forward without the proper preparation. Our advice doesn't necessarily mean, however, that you need to read the entire book from cover to cover before you purchase your first investment property.

Here, we provide a quick primer on real estate financing along with what you need to do to secure financing for your real estate investments. We also provide a generous supply of references to other chapters in the book where you can find more detailed information on specific topics. So without further ado, let the real estate financing primer begin.

Don't let negative economic and credit information dampen your desire to invest in real estate. The best time to purchase real estate is when prices are low. You can still find and secure financing; you just may need to look and work a little harder and smarter to get it.

Pumping Up Your Purchasing Power with Borrowed Money

If you have any reservations about borrowing money to buy real estate, you need to overcome those reservations by developing a better understanding of leverage — using borrowed money to buy more and better properties, thus improving your chances of earning bigger profits.

In the following sections, we show you why the goal of owning a property free and clear isn't such a smart move, reveal the secret of leveraging the power of borrowed money, and explain how you can offer "cash" for properties even when financing the purchase.

Although we encourage investors to borrow money to increase their leverage, keep in mind that borrowing money can carry significant risks. As an investor, you can take action to minimize the risks — by carefully evaluating your real estate market and properties under consideration, overestimating costs, underestimating profits, developing realistic backup plans, and so on; however you can never completely eliminate the risk. You have to decide for yourself what an acceptable level of risk is.

Minimizing your potential by owning property free and clear

For many Americans, paying off their mortgage early and owning their home free and clear is the real American dream. Life would be so much better if they didn't have to deal with a house payment.

For real estate investors, however, owning property free and clear means that valuable equity is locked up in those properties — equity they can use to finance the purchase of other revenue-generating real estate. Don't get caught in the trap of thinking that paying off a mortgage loan is a smart move — it may be a noble goal, but it's rarely a savvy strategy.

Maximizing your potential with other people's money

Other people's money (or *OPM* for short) is money that you borrow from other people to finance your investments. OPM isn't much of a secret. Assuming you own a home, you probably used OPM to buy it. You may have put down 5 to 10 percent of your own money as a down payment and then borrowed the rest.

REMEMBER

Dealing with a major credit crunch

The mortgage meltdown, foreclosure epidemic, and global financial crisis that all came to a head in 2008 led many real estate investors to believe that credit had all but dried up. Banks were failing left and right, and the United States was forced to step in with more than $1 trillion in economic rescue funds to keep cash flowing to individuals and businesses that needed credit. Surely, real estate investors would be the last on the list for cheap and easy credit.

Actually, the credit crunch didn't put real estate investors out of business. In fact, in many cases, it made conditions better for investors:

- When the bubble burst, properties became much more affordable. Investors could buy better properties for less money.
- As millions of people worked through foreclosure, demand for rental properties soared.
- Financial institutions, eager to rid their books of empty, expensive, cash-sucking foreclosures, became more willing to offer great deals. I (Chip) just had a client pay $82,000 for a brand new property with a market value of about $275,000. The bank had taken it back from a builder, was more than glad to just get it off the books, and was willing to finance it with a 15-year loan.

A credit crunch doesn't mean that financing disappears — it just means that you probably need to look for it in some unusual places. Even FHA has investor financing with 25 percent down — and a lot of foreclosures they're willing to deal on. Throughout this book, we show you how to tap into these markets — credit crunch and all.

In most cases, OPM helps you earn a profit. When you calculate in the appreciation of the home, the tax savings it represents, inflation, and other factors, you're likely to earn more money off the home than you pay out in interest over the life of the loan — barring a major housing meltdown.

The same applies to your real estate investments. The more OPM you can put to work for you, the more you stand to earn — as long as your earnings from it exceed the cost of borrowing it. For more info about OPM, check out Chapter 5.

Paying cash with borrowed money

In the world of real estate, cash is king. The buyer who shows up with cash is in a significantly stronger position to purchase a property and negotiate an attractive price and terms than a buyer who shows up needing financing.

When we say cash is king, however, we're not advising you to show up with a suitcase full of money. We're telling you to show up with preapproved financing — a financial backer who can deliver the cash on closing day. In other words, although you're financing the purchase as explained throughout this book, you're still placing yourself in a position to offer cash.

Brushing Up on Basic Real Estate Financing Lingo

Throughout this book, we toss around some jargon common in the real estate and mortgage lending industries. To the average consumer, these terms may sound Greek, but we assure you that they're part of the English language. In the following sections, we define the most common and often misunderstood of these terms.

Identifying types of lenders

The moneymen and -women you deal with when securing financing for purchasing investment property play various roles in the process. You need to know whom you're working with:

- **Commercial lenders:** They're financial institutions rather than individuals. They include banks, credit unions, mutual savings banks, savings and loan associations, and stock savings banks. (Chapter 9 discusses commercial lenders in greater detail.)
- **Private lenders:** A private lender is any individual who loans money outside the channels of institutional lending. This person can be a friend or relative, such as your Aunt Mabel, or an investor. Real estate investors often rely on private lenders for access to investment capital when banks and other financial institutions turn them down. (For more about private lenders, check out Chapter 11.)
- **Mortgage banker:** Mortgage bankers are financial institutions that directly fund home loans and either service those loans themselves (arranging and collecting monthly payments and managing any escrow accounts) or sell the mortgages to investors and contract out the servicing of the loans.
- **Servicer:** The servicer is the institution contracted or appointed to collect the monthly payments from the borrower. They have to account for all payments and disbursements and provide yearly statements showing all transactions within a mortgage account to the borrower.

- **Mortgage broker:** Mortgage brokers are licensed by the state to assist borrowers in finding mortgage lenders, comparing loan programs, applying for mortgage loans, and securing financing for purchasing real estate. They act as the eyes and ears for many different mortgage lenders.
- **Loan officer:** Loan officers work for mortgage bankers or brokers to assist clients in securing financing for purchasing real estate. They essentially do the same thing brokers do, but they have to work for a licensed broker or lender.
- **Loan originator:** Another name for a mortgage broker or loan officer.

See Chapter 4 for more on these types of lenders.

Grasping different loan types

Throughout this book, we introduce you to various types of loans for financing the purchase of real estate, including conforming and nonconforming loans, jumbo loans, and hard money loans. In the following list, we define the most common loan types and toss in some additional information that you may find useful.

- **Conforming loan:** A *conforming loan* is one that meets the criteria set forth by Fannie Mae or Freddie Mac — the organizations that purchase the loans and then package them up to sell on Wall Street. In general, to qualify for a conforming loan, the borrower must
    - Show sufficient income to cover monthly payments.
    - Have enough cash for a down payment and reserves.
    - Have a good credit history.

  For additional details about conforming loans and current criteria, visit the Fannie Mae Web site at `www.efanniemae.com`.
- **Nonconforming loans:** These include everything else outside the Fannie/Freddie box. Sometimes referred to in the market as *subprime* or even *exotic* loans, they're bought by other financial companies or investment banks and packaged to be sold to Wall Street investors. When the subprime market suffers, as it did starting in 2008, far fewer of these types of securities make it to market.
- **Conventional loans:** These loans are outside the sphere of the government. In other words, they're not FHA- or VA-secured loans and aren't underwritten by any government agency.

- **Jumbo loans:** As its name suggests, a *jumbo loan* represents a lot of money — specifically, more money than you can borrow under the limits of a conforming loan.
- **Hard money loans:** Also referred to as *bridge loans*, they're typically short-term, high-interest loans that enable investors to get their mitts on some cash in a hurry. You can expect to pay several points upfront (a *point* is equivalent to one percent of the total loan amount) plus up to double the going interest rate. (For more about hard money and strategies for using it to your advantage, check out Chapter 11.)
- **Government loan programs:** The government isn't really in the business of loaning money to homeowners and investors, but it facilitates the process for lenders by insuring the loans — if the borrower defaults on the loan, the government steps in to cover any losses for the lender.

  The two most common government loan programs are Federal Housing Authority (FHA) and Veterans Administration (VA) loans. But federal, state, and local governments also provide loan programs to encourage investment in disaster areas and neighborhoods that they're seeking to develop. Within the FHA and VA programs are some great hidden opportunities for investors. (See Chapter 4 for more about specific government loan programs.)

Brushing up on important legal lingo

Even though real estate deals are generally classified as financial, they involve plenty of legalities, especially in relation to who owns the property or has a stake in it. Although real estate–related legal terms can fill an entire dictionary, you should have a working knowledge of the following three:

- **Deed:** A *deed* is a legal document that grants rights to a property. Whenever you purchase a property, whoever is handling the closing must file the deed with the county's register of deeds to make the transfer of ownership official. As the official owner, you have the right to borrow against the property and transfer your rights of ownership.

  Be careful signing any deed, especially a *quitclaim deed* (the deed that allows a property's owner to relinquish all rights to the property). Real estate con artists often use the quitclaim deed to hijack property from unwary owners. They may hide a single page quitclaim deed in a stack of papers, fooling the owner into signing the document without knowing what they're signing. Then, they run down to the register of deeds and file the deed, making themselves the new owners, so they can take out bogus loans against the property.

Who gets first dibs?

In the event of a foreclosure, certain liens take *precedence* over others, meaning that when the property is sold at auction, certain lien holders are paid off first:

- **Tax lien:** The proceeds from the foreclosure sale pay off any unpaid property taxes first.
- **First mortgage:** If any money from the proceeds of the sale remain, it pays off the first mortgage or as much of the first mortgage as possible. This is also referred to as a *senior lien.*
- **Second mortgage:** If the homeowner took out a second mortgage, any remaining proceeds from the sale go toward paying it off. Any second (or third or fourth) mortgages are also referred to as *junior liens*.
- **Construction liens:** If money still remains, it goes to the next lien holders in order of precedence.
- **Homeowners:** After all the lien holders receive their cuts, the foreclosed-upon homeowners get the remaining crumbs, which can actually be quite a chunk of change if they had a lot of equity in the property.

- **Lien:** A *lien* is a legal claim that a creditor holds against a property in lieu of payment. Several parties can place a lien on a property, including the lender who holds any first or second mortgage, the county tax assessor (for unpaid taxes), and contractors (if they financed the repairs or renovations).

  As an investor, knowing who (if anyone) has a lien against a property you're purchasing and the monetary value of that lien is important. All lien holders need to be paid in full upon sale of the property. If the property has a lien against it that the seller fails to disclose, you may become liable for paying it when you take ownership of the property.

- **Promissory note:** Whenever you borrow money, you have to sign a promissory note pledging to pay back the loan in full according to terms of the loan, which always specifies a deadline for full payment. Think of a promissory note as an IOU (as in "I owe you" this amount of money).

  The promissory note is your pledge to pay back the loan. The mortgage or deed of trust names the property as collateral in the event that you default on the loan.

Pointing out mortgage concepts

When you take out a loan, the lender requires something of value *(collateral)* to make sure it has something valuable to sell and recoup its investment if you default on the loan. This collateral is officially presented in the form of a mortgage or deed of trust depending on the jurisdiction:

- **Mortgage:** A *mortgage* is a contract between the lender and borrower that gives the lender the right to foreclose on the property in the event that the borrower defaults on the loan.
- **Deed of trust:** A *deed of trust* is a mortgage contract that places control of the deed in the hands of a third party — a trustee. The trustee has the power to foreclose on the property in the event that the borrower defaults on the loan.

The mortgage market is large and complex, but it consists of two main divisions: a *primary* and a *secondary* mortgage market.

- **Primary:** This is the market in which you do business. It consists of financial institutions that lend you money.
- **Secondary:** This is the market where institutional lenders and Wall Street investors converge. The primary lenders who actually loan money to homeowners and investors turn around and sell the mortgages or deeds of trust to investors. This gives the lenders more money to make available to borrowers.

Examining equity

Equity is the amount of money you'd have if you sold the property today and paid off the balance due on the loan. More importantly, as an investor, you can pull equity out of a property by borrowing against it. This power enables you to put that equity to work for you in other investments.

WARNING!

Thanks to the credit crisis in 2008 and 2009, the equity requirements to obtain financing are growing. Lenders are taking a closer look at market values, especially in what they call *declining areas* — areas showing a pattern of recently declining housing values. As an investor, you should be doing the same thing. Be cautious when calculating equity positions and profit margins.

REMEMBER

Although we encourage investors to tap the power of equity, keeping some equity in a property (especially the home you own) is a good idea. Having equity to borrow against in the event of a financial setback may save you from foreclosure and bankruptcy.

Looking at loan-to-value (LTV)

The *loan-to-value* (LTV) is the ratio of the total loan amount to the value of the property. If you're buying a $200,000 home with $40,000 down and applying for a $160,000 loan, the LTV would be

$160,000 ÷ $200,000 = 80 percent

Generally speaking, lenders want to see lower LTVs for investment properties than for homes because a lower LTV provides more of a buffer to cover the increased risks inherent in investment properties. Check out Chapter 3 for more about calculating the LTV and how lenders use this number to evaluate risk.

Distinguishing Investment and Home Financing

Your first real estate investment should be your own home. In fact, if you don't own your home, we advise you to put down this book and pick up a copy of *Home Buying For Dummies* by Eric Tyson and Ray Brown (Wiley) first. Owning your own home carries the least risk and the most potential tax benefits while bringing you up to speed on the basics of real estate investing and ownership.

After you've purchased a home, you should have a fairly good understanding of the mortgage loan application and approval process. (We provide a refresher course in Chapter 7.) However, real estate financing differs quite a bit when you take on the role of investor rather than homeowner. You and the lender take on more risk. As a result, you can expect to pay more for the privilege of borrowing money. In addition, your borrowing strategy is likely to change. In the following sections, we cover these differences in greater detail, so you know what to expect before diving in.

Paying a premium for riskier investment loans

When you invest in your own home, you literally have a vested interest in making payments — if you don't, you lose the roof over your head. On the flip side, if you lose an investment property, it may be painful, but it's never *that* serious, and lenders are well aware of the difference. For them, investment loans are riskier propositions. To mitigate the risk, they generally

- Require a larger down payment.
- Demand a larger loan-to-value ratio. (See “Looking at loan to value (LTV)” earlier in this chapter.)
- Charge more interest upfront in the form of points.
- Charge a higher interest rate.
- Require proof that you have *reserves* or liquid assets available in case things don’t go as planned.

The actions that lenders take to mitigate the risks and the interest rates and fees they charge vary greatly depending on the borrower and the deal that’s on the table. Just make sure you have all the documentation and figures ready when you meet with your lender for the first time, as explained in Chapter 3.

Using quick cash to snag bargain prices

When you’re shopping for a mortgage to buy a home for your family, you’re usually looking for a low-interest package, no or very few points, and attractive terms. With investment properties, *cash flow* trumps interest rate. In other words, access to cash is often more important than the cost of the loan. To find out more about the relative importance of cash flow and how to shop for loans with the lowest interest rates and fees, see Chapter 6.

TIP

If the numbers work, what you pay in interest doesn’t matter. Interest is just another expense. If you subtract all your expenses and can still earn the profit you want, paying thousands of dollars in interest over a relatively short period is acceptable.

Accounting for taxes on your capital gains (or losses)

When buying and selling a primary residence, you don’t have to think too much about the tax ramifications of the transactions. In the United States, a huge chunk of any profit you earn from the sale is usually tax exempt — up to $250,000 if you own the home yourself or double that if you and your spouse sell the home.

However, when you’re selling investment real estate, any profits are subject to capital gains taxes. During the writing of this book, profits from real estate investments were taxed as follows:

- **Long-term capital gains:** 15 percent if you hold the property for at least a year and a day.
- **Short-term capital gains:** 35 percent if you sell the property in fewer than 12 months from the date you purchased it.
- **Income tax:** If profits from investing in real estate are your sole income, the IRS may consider it your job and tax your profits as income, complete with an additional 15 percent in self-employment tax.

We're not tax experts. Consult a CPA who has experience dealing with real estate investors for details on how the government is going to tax your profits and for suggestions on how to reduce your tax burden. Your measure of success isn't how much you gross but how much you net. By reducing your tax bill, you can significantly increase your net gain.

Protecting your personal assets

Just like most things worth doing, real estate investing exposes you to risk. Perhaps the biggest risk is that you're working with borrowed money from lenders who expect you to pay it back. If you make a lousy investment decision or an investment goes belly-up despite your best efforts, lenders are going to do everything legally possible to collect their money.

You also face the ever-present risk of litigation — having a disagreement with a buyer, seller, tenant, contractor, or someone else that eventually leads to a costly lawsuit.

Eliminating risk isn't possible, but you can take several measures to lessen the risk, including operating through an LLC, transferring personal assets to someone else, or having a qualified attorney cover your back. Check out Chapter 2 for more details.

Exploring Common Sources of Investment Capital

You probably picked up this book because you want to start investing in real estate, but you don't know where to dig up the cash to do your first deal. In the following sections, we show you where to start digging.

Tapping your own cash reserves

If you're single, or you and your significant other are on the same page about this real estate investing thing, cracking into your nest egg to finance your investments may be the quickest way to get your fingers on some investment capital.

It's also the riskiest option, because if anything goes wrong — you get laid off or fired, become too ill to work, or encounter unexpected expenses — you have fewer reserves to keep you afloat. In addition, limiting yourself to your own resources also limits your purchase power — you have to buy houses in a lower price range and may not have sufficient cash to properly renovate the property.

WARNING!

A great way to ruin a relationship is to bet the farm on big profits without the knowledge and complete agreement of your spouse or significant other. If your investment doesn't pan out (and even if it does), the other person may take offense at not being consulted.

Even with these caveats, many beginning investors have gotten their start by financing their own ventures — partially or in full. And you want to know about these resources if you need some quick cash in a pinch.

Clearing out your bank accounts

Having a few thousand dollars socked away in a savings account is always a good idea, just in case you run into a cash flow problem. If that house you bought and fixed up is taking a few months longer than expected to sell, your little nest egg can help cover the payments until you find a buyer.

REMEMBER

Use your savings as a reserve, not as your main mode of financing. Having some cash to fall back on can save you in a pinch.

Borrowing against the equity in your home

As your home's value rises and you pay down the principal, you build equity. You can often borrow against this equity by taking out a home equity loan or line of credit and then use the money for whatever you want, including purchasing other real estate. The recent credit crisis has made it harder to find these loans, but they're still out there for well-qualified borrowers.

We don't recommend that you cash out all the equity in your home, but if you have a substantial amount of equity, cashing out a portion of it can help you come up with a down payment or cover the cost of repairs and renovations. (For more about home equity loans and lines of credit, skip to Chapter 11.)

Financing investments through a self-directed IRA

More and more investors are choosing to set up *self-directed IRAs* and other types of retirement accounts that enable them to invest in real estate rather than in stocks and bonds. The reasoning: Real estate often provides a better and sometimes even more secure return on your investment.

With a self-directed IRA, you can buy and sell properties out of your retirement account. Setting up a self-directed IRA, however, is no simple matter. Typically, a trust company manages the money and properties in the account, and all profits and losses from your investments must stay in that account. Withdrawing money from the account results in the same IRS penalties you have to pay if you withdraw money from any type of retirement account.

Consult your financial advisor and accountant for details about using a self-directed IRA to finance your real estate investments. If a self-directed IRA isn't an option, you may be able to borrow money against your retirement account. Keep in mind, however, that borrowing against your retirement savings places those savings at risk, as does any other investment.

Charging expenses on your credit cards

Maxing out your credit cards to purchase a car, clothes, electronics, groceries, and other items that provide no return on your investment is never a good idea. Using your credit cards to purchase investment properties that offer a solid, relatively quick return on your investment, however, can be a savvy (though risky) financial move.

Consider credit cards a last resort to cover the costs of repairs and renovations if financing is tight near the end of a project. With this strategy, your investment activities can directly affect your personal finances, which increases your exposure to risk. For more about this option, check out Chapter 11.

Borrowing from commercial lenders

One of the best ways to finance the purchase of investment properties is to meet with a qualified mortgage broker who can help you find and evaluate various loan programs. These plans are often your best deals — costing the least in upfront fees and interest.

For more about finding commercial lenders, check out Chapter 4. If you're investing in residential property, Chapter 5 reveals the various residential loan programs to choose from. If you're buying commercial property, turn to Chapter 9 for guidance on choosing the right loan program.

Don't confuse "commercial property" with "commercial lender." A *commercial property* is any property that isn't a one- to four-family residential dwelling. A *commercial lender* is an institution (as opposed to an individual) that loans money. In other words, you can use a commercial lender to finance the purchase of residential investment property.

Obtaining a hard money loan

When banks and other financial institutions turn down your requests for investment capital (or you don't have the time to convince them that a deal is pure gold), consider borrowing money from a hard money lender, as explained in Chapter 11.

One of the main advantages of a hard money lender is that the person is likely to accept the property you're buying as all the collateral needed to secure the loan, so you don't have to place your home at risk.

Financing your purchase through the seller

Property owners who are eager to sell and don't need all the cash at once are often willing to finance the purchase themselves. This tactic enables them to profit in two ways — by selling you the property for more than they paid for it and collecting interest from you. Seller financing take either of the following forms:

- **Land contract:** A *land contract* is like a mortgage, except the seller acts as the bank.
- **Lease option agreement:** A *lease option agreement* is like a rent-to-own deal — you lease the property for a specified period, at the end of which time you have the option to buy it.

For more about seller financing, check out Chapter 12.

Taking on a partner

Whenever you don't have something (like money, skills, time, or talent) to accomplish a particular goal, you can acquire those skills, buy or hire them, or create a partnership with someone who already has what you need. If you have something someone else needs and they have what you need, you have what it takes to form a mutually beneficial relationship. For details on how to partner with someone who has the cash you need, check out Chapter 13.

Choose a partner as carefully as you choose a spouse. Partnerships often end when one person scams the other or disagreements arise over who's putting more into the projects and who's getting more out of them. Have your attorney write up a contract, complete with a prenuptial type agreement stating how all the assets will be divvied up in the event that you part company.

Prepping to Meet with a Lender

Walk into a bank empty-handed and explain to the loan officer that you need a loan to start investing in real estate, and we can almost guarantee that you'll be laughed out the door. Before you even think about meeting with a prospective lender, get all your ducks in a row. Copy all the financial documents lenders are going to ask for and construct a fairly detailed plan on how you're going to profit by investing in real estate. This section gives you an overview of what you need to do before visiting your lender. Chapter 4 provides complete in-depth info.

Gathering paperwork and other info

Before approving your request for a loan, lenders want to know whether you're good for the money — how likely you are to make the monthly payments and pay back the loan in full. For investors, this means two things:

- You're in pretty good financial shape right now and have a fairly clean credit history.
- The property you're planning to buy is more than worth the money you're borrowing to pay for it, and (if you're going to be renting out the property) it will generate sufficient income to more than cover all your expenses along with the monthly payments.

To verify your creditworthiness for yourself and be sure you have all the documents and other information your lender requires, stuff a folder full of a copy of each of the following items:

- Credit reports from all three credit reporting agencies
- A net worth statement (assets – liabilities = net worth)
- A debt ratio statement (ratio of what you owe to what you own)
- Last two months' bank statements
- Last 30 days' pay stubs

- Last two years' federal tax returns and schedules
- Statements of any business income
- Appraisal or comparative market analysis for the property
- Cash flow analysis of the property
- Loan-to-value ratio of the property
- Zoning information for the property's location
- City and county records for the property

Crafting a business plan

Real estate investors often scoff at the idea of creating a *business plan* — a detailed presentation that shows how an investor plans to purchase a specific property and earn a profit from it. Investors often just want to buy and sell and rent out property and make a lot of money — that's the plan. They don't like to think of themselves as pencil-necked pencil pushers. If they feel in their gut that a property is a solid investment, that's good enough for them.

At least that's the false image that many people have of investors. The most successful investors, however, do the math. They crunch the numbers. And if the numbers don't work, they don't do the deal.

Do your homework. Do a comparative market analysis of the property to make sure it's worth what you think it's worth. If you're buying rental property, check the rental history of the property — the owner's tax records showing income and expenses. Craft a business plan showing exactly how this property is going to be a revenue generator.

Chapter 2

Shielding Your Personal Assets from Investment Risks

In This Chapter

- Grasping the need to cover your assets
- Investing as a corporation to reduce your exposure to risk
- Assigning ownership of certain assets to others
- Avoiding collateral and cross-collateral damage
- Dodging real estate and mortgage fraud

Funny thing about lenders — when you borrow money from them, they expect you to pay it back. To ensure repayment of a loan, the lender usually requires that you sign a promissory note and a mortgage or deed of trust. The *promissory note* is your personal promise to repay the loan in full. The *mortgage* or *deed of trust* names certain property as collateral for the loan.

If you happen to *default* on the loan (fail to make payments as stipulated), the lender has the right to *foreclose* (sell your property to the highest bidder). If the lender can't sell the property for at least as much as you owe on it, it may be able to sue you for the difference *(deficiency)* in jurisdictions that allow deficiency judgments.

As an investor, you want to limit the assets that the lender has the right to seize in lieu of payment. If you fail to make payments on a loan you took out to purchase an investment property, for example, you want to make sure that the bank can't take possession of the home you live in, other businesses you own, or other assets, such as your car. To prevent the lender from going after personal assets and other business assets as payment, you need to *shield* those assets — keep them legally and financially separate from your investment properties. In this chapter, you discover various strategies for doing just that.

It's a jungle out there. Fraud is more common in the real estate industry than most professionals are willing to admit, so in this chapter, we also show you how to protect yourself against becoming a victim or unwitting accomplice to real estate and mortgage fraud.

Understanding Why You Need to Protect Your Personal Assets

As an investor, you're a small-business owner, but you're also an individual who may have a spouse and a family to support. You probably have a home, a car, one or more personal bank accounts, a retirement account, and other valuables that you've worked very hard for a long time to accumulate. You want to build even more wealth by investing in real estate, and you're willing to take some risks, but can you live with losing everything you now own?

The correct answer is (or should be) "no." No, you shouldn't risk everything you now own to invest in real estate. Why? We can think of two very good reasons:

- You don't want to or have to risk everything. You can protect some or all your assets from risk by following the advice we offer in this chapter.
- If your investment goes belly up, you can recover much more quickly and perhaps even pursue future investments by holding on to more of your current assets.

In any investment, you should try to limit your exposure (both financially and emotionally) to the individual deal. You're investing your time and talent and perhaps a little of your own money. In addition, you're the one who's taking on the burden of managing the project, dealing with hassles, and worrying about whether your investment is going to eventually turn a profit. All the lender is doing is putting up the money, so let the lender step up to the plate and take the *financial* risk. That's the price it pays for being able to do business with you.

Limiting Your Personal Liability by Forming an LLC

Businesses form corporations for any number of reasons, but one of the primary reasons is to establish the business as a separate entity. If, for example, you do business in your own name, you become personally liable for anything that happens in the course of doing business. If someone decides to sue you over something related to your business, all your personal belongings are at stake.

By setting up a corporation, you essentially create a fall guy who takes the blame if something terrible happens. A customer can sue your corporation to the point of bankruptcy, and in most cases, you can simply walk away with your home, your car, and your personal savings and belongings all intact.

One of the best and most popular corporate entities for real estate investors is the *limited liability company* or *LLC*. By forming an LLC, you limit your exposure to risk to the company, so it can fold without negatively affecting your personal finances.

In the following sections, we provide guidelines on setting up an LLC and managing your investments through it. For details about creating and managing an LLC, check out *Limited Liability Companies For Dummies* by Jennifer Reuting (Wiley).

Understanding the pros and cons

On its surface, an LLC appears to be the best of all possible business entities, and in some ways it really is, but prior to taking the plunge, consider its potential advantages and disadvantages.

An LLC offers the following benefits:

- **Generally requires less paperwork and fewer hassles:** Small business owners who form S-corps often get frustrated pretending that they're some huge corporation — filing all sorts of forms, holding or pretending to hold corporate meetings, and keeping a record of each meeting's minutes. With an LLC, you avoid most of that nonsense — at least the meetings and the minutes.
- **Provides greater protection:** Operating as a sole proprietorship leaves you completely vulnerable to lawsuits and other legal claims against your personal assets. An LLC provides the same sort of protection you can expect under the corporate umbrella.
- **Allows you to dodge the passive income bullet:** If too much of your income from real estate holdings is classified as *passive*, the IRS could convert your Sub-S into a C-corp (a regular corporation), exposing you to double taxation. With an LLC, you can do a *pass-through,* in which your real estate earnings pass through the company and are treated as personal income so that the company isn't taxed separately, as well.

Although an LLC offers the protection of limited liability, it does have a couple of its own limitations, as well:

- If a member of the LLC dies or goes bankrupt, the LLC is dissolved, whereas a corporation can continue to exist as long as it has shareholders.
- All properties within the LLC are exposed to risks associated with the other properties held in the same LLC. In other words, someone trying to collect money for one of the LLC's properties can go after the other properties to collect payment. For this reason, limiting the number of properties held in any one LLC is a good idea.

Setting up an LLC

Anyone with a free weekend, a computer, and an Internet connection can set up an LLC (although we recommend that you use an attorney). You download the forms, fill them out, and submit them to your state commerce department, secretary of state, or bureau of corporations. Although each state has slightly different procedures to follow and forms to complete, you should be able to find all the instructions and documents you need on your state's Web site.

TIP

Go to your favorite online search engine and type in "corporation" followed by the name of your state — for example, "corporation Arizona" (without the quotation marks). This search should bring up a link to the department in your state that handles LLCs and corporations.

You can set up most LLCs on your own for very little expense and paperwork, but we encourage you to consult with an attorney. A savvy attorney can ensure you've set up your corporate shield in a way that makes it less vulnerable to being pierced. You may also want to hire an accountant to manage the finances for the company and ensure that any taxes that come due are paid on time.

TIP

The choice of which state you form your corporation in is of utmost importance, especially in terms of how you're taxed. Delaware, for example, is very corporation-friendly, which is why you see so many financial institutions, especially credit card companies, centered in Delaware. Discuss the options with your accountant and attorney.

Taking and securing title to real estate

When you have an LLC in place, perform all business transactions in the name of the LLC rather than in your own name. Whether you're taking out a loan, signing a purchase agreement, or putting your John Hancock on closing papers, make sure your LLC is listed as the responsible party and that you're signing as a representative of the company.

Accomplishing this task is fairly easy on your part because other people are usually in charge of drawing up the paperwork. All you need to do is instruct the person (real estate agent, closing agent, loan officer, or whoever is handling the paperwork) to prepare it in the name of the LLC.

Unfortunately, on conventional loans with conventional lenders for typical one- to four-family dwellings, getting a loan in the name of the LLC is nearly impossible, but you can still have the LLC *hold* the property, providing some protection from personal liability. You have an easier time taking loans out in the name of the LLC when purchasing larger properties (5+ units) and commercial deals.

If you can't take title in the name of your LLC, move the property into the LLC as soon as practical. You can do this by using a *quitclaim deed* — typically a one-page legal document that enables you to deed the property to another individual or business entity. You simply sign the quitclaim deed, specifying that the LLC is the new deed holder, and then file the quitclaim deed with your county's register of deeds. Your attorney can supply you with a quitclaim deed that's valid in your county.

WARNING!

Follow your attorney's advice carefully, because this strategy can trigger a *due-on-sale clause,* in which case you would need to pay back the loan in full immediately. The IRS allows investors to transfer real estate for estate-planning purposes, so you're in the clear as long as you follow the rules.

WARNING!

Some LLCs choose to perform certain transactions under an *assumed name* — a name that differs from that of the company. We strongly discourage the use of assumed names in real estate transactions, because they provide little, if any, protection for you. Always transact your investment business under the LLC's name.

Eyeing Sub-S corporations and partnerships

Although we recommend LLCs for most investors, a Subchapter S corporation (or Sub-S for short) is a viable alternative. A Sub-S is an actual *corporation* (as opposed to a *company*) that chooses not to pay taxes on earnings but instead have those earnings pass through to the shareholders so they pay taxes on them. It's another way of dodging the double-taxation bullet (taxing the corporation as well as the individual shareholders).

A Sub-S can also provide you with a great measure of protection and allow for other deductions and a wider variety of activities than are possible under an LLC. For example, a Sub-S allows you to partner with other business entities in addition to individuals.

REMEMBER

If you plan on partnering up with another investor, you need to formalize the relationship by forming a partnership, as we discuss in Chapter 13. A *partnership* is simply a business entity in which the members agree to work toward a common goal. You need to have a written agreement in place that stipulates how the partnership functions, who's responsible for what, and how assets are to be divided should the partnership dissolve. The partnership itself, however, provides you with little or no protection. You still need to set up a corporation or an LLC for protecting your personal assets and those of your partner(s).

Transferring Personal Assets via Trusts

As an investor, you're a business owner, and most responsible business owners keep their business and personal finances separate. You can be sued by anyone at any time, and you want to protect your family and personal assets as best as possible. An excellent way to accomplish this is to place your personal assets under someone else's name or into a separate entity — a *trust.* Consider the following options:

- Transfer personal assets to your spouse, one of your children, another relative, or a designated third-party administrator such as an attorney or financial planner.
- Shift your assets into a *trust* — a legal device you as an individual place your assets in for the benefit of others, such as your family.

TIP

Investors often spend a great deal of time and effort building wealth only to see the fruits of their efforts chipped away by unjustified lawsuits and taxes. By holding your assets in an estate or trust, you not only protect them against legal claims, but you can also reap substantial tax benefits. Sophisticated investors often use multiple business entities (including LLCs and other corporate structures) to manage their assets and protect them from a variety of risks. As you acquire more properties, consider employing a similar strategy. For more about estate planning, check out *Estate Planning For Dummies* by Jordan Simon and Brian Caverly (Wiley).

In the following sections, we address the advantages and disadvantages of placing your assets in someone else's name and assist you in deciding which option is best for you.

Weighing the pros and cons of owning property in another's name

Investors and business owners often protect assets by placing them in the name of a spouse or other relative. Before you make this move, however, you need to have a firm grasp of the pros and cons to protect the property.

Some investors hold some investments in their own names, and some in the name of their spouses. This strategy increases the number of properties you can finance (by getting around Fannie Mae and Freddie Mac limits on the number of residential properties/mortgages you can hold) and also enables you to diversify your assets and limit liabilities.

A real estate investor, for example, may choose to have her spouse listed as the sole owner of their home, car, and other big-ticket assets and then take out loans and the title to investment properties in her own name only. If she defaults on a loan, she can lose the investment property, but the family home and car are safe.

So, what's the catch? Placing assets in someone else's name can increase your exposure to several risks:

- **You lose some control over those assets.** If all your personal assets are listed in your husband's name only, for example, a divorce may leave you at a severe disadvantage.
- **You may affect your kids' future financial aid.** If you own property in the name of your children, the value of that property can influence the financial aid calculations should your children decide to attend college and require financial assistance.
- **You may encounter tax consequences.** Putting assets in the names of your children may also trigger gift tax requirements or estate tax issues.
- **You're at the mercy of that person's legal issues.** If the holder of your assets becomes disabled or runs into his own liability issues, your assets can get tied up for a long time in the legal wrangling. Bankruptcy, insolvency, or even death (and the subsequent probate) can turn the best of plans into a financial fiasco.

REMEMBER

Placing assets in someone else's name can be a bit of a hassle, but it usually doesn't cost all that much. For example, you can head down to the bureau of motor vehicles and change the name on the title for any vehicles you own for a small fee. Likewise, you can use a quitclaim deed to assign ownership of a property for a small recording fee. Before you do, however, consult your attorney or accountant to find out about all the ramifications of transferring ownership of your properties because the laws and procedures vary from state to state.

Gaining asset and tax protection with an irrevocable trust

Trusts are the most versatile tool for transferring title of assets without tax implications or increased risk, but they have some limitations. We encourage you to discuss your situation with a qualified estate planner who can assist you in weighing the potential benefits and drawbacks of different options and then set up the trust for you.

Trusts come in two flavors — revocable and irrevocable. A *revocable* trust is one you can change or terminate during your lifetime. An *irrevocable* trust is one that you can't change or dissolve — as *grantor* (creator of the trust), you no longer own the assets held in trust. The trust does. An irrevocable trust benefits you in two important ways:

- Because you no longer own the assets, they're protected against any legal actions taken against you.
- The property and its appreciation are outside of your taxable estate, allowing you to avoid paying estate taxes on the value of your holdings.

Both revocable and irrevocable trusts protect assets from probate, but only irrevocable trusts can eliminate estate taxes.

TIP

The ultimate way to protect assets is to hold them in an offshore asset protection trust, but we're not advising that you do that. The next best thing is to have your assets owned by a Sub-S or LLC and then have the shares of the corporation owned by an irrevocable trust — this is the fortress of U.S. asset protection. The IRS frowns upon any sort of tax optimization scheme, particularly the offshore variety, so before employing any such scheme, consult a tax attorney.

Considering real estate investment trusts (REITs)

Real estate investment trusts (or REITs for short) give small investors a way to pool their assets and own investment real estate as a group. REITs offer investors three significant benefits:

- **Investors can diversify their real estate holdings by owning pieces of multiple properties.** Instead of purchasing a $200,000 property, for example, a small investor can own a $10,000 share in 20 properties, spreading the risk.
- **Small investors can afford to buy into higher-end real estate.** REITs allow minor league investors to play a smaller role in the major leagues, because it costs less to buy in.
- **REITs simplify the transfer of ownership to different investors.** Instead of selling the property, you simply transfer shares.

TIP

If you have an LLC with 100 or more investors, consult your attorney for assistance in setting up a REIT, to ensure that it meets all the requirements, including the following:

- Your REIT must have at least 100 shareholders. Why 100? That's just one of the rules.
- You must distribute at least 90 percent of your REIT's taxable income. In other words, at least 90 percent of the profits earned by the assets in the REIT must flow through to shareholders.
- Ninety five percent of your REIT's income must come from financial investments (including real estate, securities, and annuities), with 75 percent of that total coming from real estate (net profit from sale of assets, rent/lease payments, and so on).

Staying Away from Promissory Notes with Recourse Clauses

Promissory note is a fancy term for an IOU. Whenever you borrow money, the lender almost always requires that you sign a promissory note promising to pay back the money under a set of specific conditions, including the *term* (amount of time you have to pay the loan in full), interest rate, *principal* (total amount you borrowed), and payment amount of each scheduled payment.

Promissory notes usually include a *recourse clause* stipulating that the person signing for the loan is pledging individual assets as additional collateral to secure the loan. If the loan goes bad, the lender can then come after the borrower's personal assets to recoup any losses.

In the following sections, we explain nonrecourse loans (the most desirable option), discuss what you need to do if your contract has a recourse clause, and point out the risks involved in *cross-collateralized loans* — loans that enable the lender to lay claim to property other than the property the loan was used to purchase.

Opting for a nonrecourse loan

If you're trying to borrow money for a potentially lucrative investment, a recourse loan may be your only option, but in most cases, you want a loan that places only the property you're financing at risk — a *nonrecourse loan*.

Nonrecourse means that the property stands on its own. Fail to make your payments, and all you stand to lose is the property you borrowed the money to buy . . . and your pride. Borrowers typically use nonrecourse loans for financing the purchase of larger commercial-type properties, where the lender understands that the real value is in the property and the income it generates. If a $15 million loan on a hotel goes bad, the lender knows he can't shake enough quarters and nickels out of you to pay it back. Instead, he can get the money out of the property.

In some cases, lenders allow you to buy into a nonrecourse clause by paying a higher interest rate or agreeing to other terms that are more favorable to the lender. It never hurts to ask, but on smaller properties, you can usually count on having to agree to some sort of recourse clause. (See the next section for more on how to negotiate this recourse clause.)

Any type of fraud, misrepresentation, or misappropriation of funds in respect to the loan or the property — such as claiming that the building generates more rental income than it really does — can void the nonrecourse clause and give the lender the right to come after your personal assets.

Negotiating the recourse clause

Although we suggest you go the nonrecourse route as often as possible, some contracts require a recourse clause. Fortunately, this clause is usually negotiable. A lender typically doesn't remove it entirely, but you may be able to negotiate a recourse clause that limits your liability. Ask your loan officer or broker whether any options are available. Following are some areas that may be open for negotiation:

- **Property limitations:** You may limit the recourse, for example, to other real estate holdings in your LLC, thus protecting your personal residence and other assets.
- **Time limitations:** You may be able to place a time limitation on your liability; for example, if you make payments on time for five years, your personal liability is released.
- **Partial recourse:** This provision limits your liability to a certain percentage of the loan or a certain amount (less than the full amount). Partial recourse can also limit the lender's ability to collect only under certain conditions.

WARNING!

Almost every residential loan (for one- to four-family investment property) requires personal recourse. Just make sure you understand the limitations and options. When signing a promissory note, make sure that the recourse clause is limited to the assets you're willing to put at risk.

Avoiding cross-collateralization

To protect their money, lenders like to know that you have plenty of *collateral* — anything of value that they can take from you and sell to get their money back in the event you're unable or unwilling to pay back the loan. When the housing market is thriving and property values are on the rise, lenders tend to accept the property you're financing as collateral on the loan. If you don't make your payments, they can foreclose, sell the property, and get back all or nearly all their money.

Your recourse to recourse loans

I (Chip) once had 16 doctors who went in together on a commercial building as an investment. The bank wanted a full recourse loan on each of them, which would have given them a total of 1600 percent coverage on the loan. We negotiated for a 10 percent personal recourse on each investor, which still provided the lender with 160 percent coverage. We were also able to eliminate personal liability after five years of satisfactory payments.

The moral of this story is this: Don't accept what the lender offers as a final offer. As long as you're a serious investor with a solid plan in place, you can usually negotiate more attractive terms with the lender.

Cross-collateralization nightmare

Several years ago, I (Chip) had a friend who had a great idea for a retail clothing store. Couldn't lose, or so he thought. Unfortunately, his overconfidence led him to be careless in borrowing money for his new venture. He allowed the loan he secured to buy the building to be cross-collateralized with the store's inventory and many of his personal assets.

A sharp downturn in the market transformed his dreams to dust in a mere 18 months, but the worst was yet to come: The lender not only foreclosed on the building and took his inventory but also went after his home, car, boat, and retirement fund. The financial strain eventually ended his marriage.

Any investment that's worth pursuing usually involves some risk, but going all in when you don't really have to is folly. By avoiding the cross-collateralization trap, you limit your risk to the new investment.

No investment is a sure thing. Protect yourself from unforeseen and unfortunate circumstances as much as possible.

On riskier investments — when property values are declining or the property's value is close to the amount being borrowed or a large loan is being taken out to purchase multiple properties — the lender may want to *cross-collateralize* the loan. With cross-collateralization, two or more properties act as collateral for a single loan. If you fail to make payments on the loan, the lender can foreclose on other properties to collect the amount due.

WARNING!

For the investor, cross-collateralization exposes other properties to the liabilities of one. Stay away from these types of loans if at all possible. You can't always avoid cross-collateralization, but we encourage you to at least try. Otherwise, you may lose a good income property just because one of your other properties is a dog.

Steering Clear of Real Estate and Mortgage Fraud

Wherever you find money, you find crooks — con artists determined to score some quick cash. As a real estate investor, you're vulnerable to real estate and mortgage fraud in any or all of the following three ways: as a target, as a perpetrator, or as an unwitting accomplice. And all these roles can ultimately undermine your long-term success, not to mention your reputation.

Refusing to play a role in fraud for housing

Fraud for housing used to be the most common type of real estate and mortgage fraud and the most "harmless" (although still illegal). It consists of lying on a loan application so you can purchase a home to live in – as opposed to "fraud for profit," in which you're committing fraud to obtain money.

When you're acting as an investor, you're at a pretty low risk of becoming a perpetrator of fraud for housing because you're not buying the property to live in it. However, you may be at risk for becoming an accomplice if you're trying to sell a property to buyers who are having trouble qualifying for a mortgage loan.

If prospective buyers are having trouble qualifying for a loan to buy the property you're selling, they may just not be able to afford the payments. Don't try to "help" them by encouraging them to lie on their loan application or by referring them to a loan officer who's known for bending the rules.

In the following sections, we describe the main types of real estate and mortgage fraud, to empower you to steer clear of scams and schemes that can get you into trouble.

Ignorance of the law is no excuse for breaking it. Unfortunately, ignorance is as rampant as fraud in the real estate industry. Many real estate professionals may try to convince you that something illegal is okay because everybody does it or because these are "victimless crimes." However, as we've seen from the mortgage meltdown beginning in 2008, homeowners and investors ultimately pay the price. For more about real estate and mortgage fraud, check out *Protect Yourself from Real Estate and Mortgage Fraud: Preserving the American Dream of Homeownership* by Ralph R. Roberts and Rachel Dollar (Kaplan Publishing).

Telling the truth on your application

A huge percentage of real estate and mortgage fraud could be eliminated if everyone in the industry, including investors, would work together to ensure that all the information on loan applications is complete and accurate.

Buyers and those who assist them often think that accuracy is optional, but the loan application, the 1003 (commonly referred to as a ten-oh-three, or officially as the Uniform Residential Loan Application), clearly states, just above the space for your signature, the following:

> I/We fully understand that it is a federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

What constitutes a *false statement?* Here's a list of what may be considered false:

- Stating or providing false records that you're employed somewhere you're not.
- Stating or providing false records of income.
- Providing false identification.
- Boosting your credit score by piggybacking on someone else's better credit.
- Falsifying ownership of assets, either by stating that you own items you don't or by renting assets. (Some disreputable companies allow you to rent assets, so you appear to own more assets than you really do.)
- Failing to disclose a silent second. A *silent second* is a separate mortgage typically taken out to cover the down payment. As we discuss in Chapter 14, taking out a second mortgage to finance the down payment is okay, but not disclosing it is illegal. It creates the false impression that you're more financially secure than you really are.

Dodging predatory lenders

Although lenders are often the victims of mortgage fraud, they may also be guilty of committing fraud and are even more frequently guilty of lending practices that prey on uninformed borrowers. Whenever you're applying for a loan, keep one hand on your wallet and one eye out for the following questionable and perhaps illegal lending practices:

- Charging you higher-than-normal loan origination fees (including points).
- Encouraging you to bend the truth on a loan application, so you can qualify for a loan you would otherwise not qualify for.
- Having you sign a blank loan application and then filling in the details for you later.
- Refinancing your mortgage repeatedly within a short period of time.
- Selling you a high-cost, high-interest loan when you would qualify for a low-cost, low-interest loan.

- Adding products or services such as credit life insurance to a loan without adequately informing you about the need or cost of these products or services. Watch out for hidden (undisclosed) fees.
- Selling you products or services that are nonexistent or offer no benefit.
- Convincing you to borrow more than you can reasonably afford to pay back.
- Pressuring you to accept high-risk loans, such as balloon-payment loans, interest-only mortgages, subprime or adjustable rate mortgages (ARMs), and loans with high prepayment penalties.
- Selling high-interest loans based on ethnicity or nationality rather than your credit history and financial situation.

TIP

Always obtain three or more quotes from different companies before choosing a loan and compare the quotes carefully (see Chapter 6 for details). Doing so enables you to see any hidden loan costs more clearly. When applying for and closing on a loan, read the documents carefully to make sure the information is accurate and complete.

Saying "no" to inflated appraisals

One of the main instruments that real estate con artists use to ply their trade is the *inflated appraisal* — a document showing that a property is worth significantly more than its true market value. By obtaining an inflated appraisal (forging one or paying off a crooked appraiser), the con artist can create equity in a property where none exists.

As an investor, never try to sway the opinion of an appraiser or allow a loan officer, real estate agent, or anyone else to convince you to go along with a deal that involves an inflated appraisal.

WARNING!

Also, be careful about overpaying for a property whose value has been artificially boosted by inflated appraisals. You can protect yourself by ordering your own independent appraisal before purchasing a property. Find an appraiser in the area who has a solid gold reputation and plenty of experience in the market you're buying into. Don't let the seller or seller's agent recommend an appraiser. You pay a few hundred dollars for your own appraisal, but it can save you from making a mistake costing tens or even hundreds of thousands of dollars.

We also recommend against using online appraisals or computerized valuation models. You want a real live person, a qualified appraiser who knows the local market, to physically inspect the property and provide you with an educated estimate of its market value. There's really no substitute.

Turning your back on cash-back-at-closing schemes

One of the most prevalent forms of fraud, particularly when the market is down, consists of providing the buyer with *cash back at closing*. The buyer agrees to pay more for the property than it's worth and obtains an inflated appraisal showing that the property is actually worth the purchase price. The seller agrees to raise the asking price and kick back the excess money to the buyer at closing. Many people think these arrangements are okay, but don't be fooled — cash back at closing is illegal. Protect yourself:

- Don't offer buyers cash back at closing or any other "perks" that the lender is actually financing, including "free" furniture, a cruise, upgrades, and so on.
- Don't accept cash back at closing, even if it comes in some other form, such as "free" furniture, upgrades, rebates, refunds, or anything else that's actually being paid out of the loan amount.

Avoiding illegal flipping

Flipping houses, as described in *Flipping Houses For Dummies*, is perfectly legal. You buy a house below market value, fix it up, and then sell it for a profit. However, another type of flipping is clearly illegal. It consists of buying a property, typically a dilapidated house, at well below market value, doing a few cosmetic repairs to make it look nice, and then selling it for much more than its true market value.

As an investor, avoid illegal flipping. In addition to breaking the law, this type of flipping ruins your long-term success. Illegal flippers may score some quick cash, but they quickly ruin their reputations and often end up in legal trouble. It's not worth it.

TIP

To avoid becoming the victim of an illegal flip, always check the recent sales prices of similar homes in the same neighborhood to make sure the asking price of the property you're about to purchase is realistic. Make sure you're the one choosing the home inspector and the appraiser. If the seller offers to handle this for you, politely decline the offer.

Defending yourself against chunking schemes

Real estate investors often become the targets of con artists through what is commonly referred to as a *chunking scheme*. The con artist dangles a quick-cash, no-hassle investment opportunity in front of the eager investor and offers to take care of all the details. The investor only has to put up the cash or sign the papers for the loan that to finance the deal.

The organizer promises to place renters, collect the rent, make the mortgage payments, and so on, and tells the investor that the rental payments will cover the mortgage and maybe even earn a little extra cash each month. The investor can sell the property at any time and profit from it because the property is sure to appreciate.

The truth behind the deal is that the properties are usually overvalued, the renters don't exist, and the con artist never intends to make the mortgage payments. Investors are left with dilapidated homes, unpaid mortgages, and destroyed credit.

TIP

The best way to avoid getting sucked in by a chunking scheme is to plug your ears when you hear someone pitching a no-risk, no-hassle way to earning riches in real estate. Quite frankly, such deals don't exist. Do your homework. Visit the property and inspect it with your own two eyes. Oversee the management of the property. Don't let someone else "handle all the details" because they probably intend to handle you out of your money.

Refusing a builder bailout

Builders who become overextended may try to dig themselves out of a financial hole by selling homes (or whatever they're building) before completion to unsuspecting buyers. In some cases, the builder eventually completes the project. In other cases, he may take the cash and leave the buyer with an unfinished building or even a vacant lot.

When banks finance new construction (see Chapter 9), they don't give the builder all the money at once. They set up an account that the builder draws from during the building process. The bank wants to make sure the project is completed, so it ties the cash draws to success and to certain milestones. When those milestones are completed, the bank can then free up the money to pay for the supplies and services. For example, if the rough lumber needed for a project costs $28,000, the bank would give the builder a draw for $28,000, which would then flow to the lumber company *after* the framing was complete. The lumber company would then sign a waiver of lien, acknowledging payment and freeing up its claim to the property.

When a builder becomes strapped for cash, he may try to get the money sooner by employing any of the following strategies:

- Falsifying inspection reports
- Submitting fake certifications of work performed
- Fooling the inspectors by removing items from some buildings and installing them in others to make it appear as though progress is being made
- Selling an incomplete property to the buyer

TIP

The best way to avoid builder bailout scams is to choose a reputable builder and refuse to close on the deal until you have the building thoroughly inspected by a professional inspector of your choosing.

Acting with integrity: The golden rule

Far too many investors succumb to the temptation to commit fraud because they're in a hurry to make a quick buck. All these "investors" eventually fail because they tarnish their own reputations and damage the very industry that puts money in their pockets.

REMEMBER

The best way to achieve long-term success as a real estate investor is to make a commitment to follow the golden rule — treat others as you would want to be treated. You can still earn a handsome profit in real estate by purchasing properties legitimately and setting a fair price when you sell. You don't have to break or bend the laws to be successful. You just need to do your homework.

Chapter 3

Gathering Essential Documents, Facts, and Figures

In This Chapter

- Obtaining, checking, and correcting your credit history
- Gathering all the facts, figures, and documents you need
- Keeping track of where all your money's coming from
- Telling the difference between prequalification and preapproval

Lenders aren't exactly tripping over themselves to lend money, especially in the recent credit debacles of the mid-2000s. They want to know who they're lending it to, for what, and how and when they're going to get paid back. They usually operate conservatively, weighing the risks before quoting you a price. If they see your venture as too risky, they may reject your loan application outright. If they believe you're in a strong position to pay back the loan in full, they may offer you financing at lower interest rates to win your business. If they see you as a moderate risk, you may receive financing at higher rates.

In any event, the lender wants to see how you look on paper — the value of what you own, how much you owe, how much you earn, your credit history, and so on. Before you even think about applying for a loan, gather all the documents and information that lenders are likely to request. This chapter leads you through the process.

Examining Your Credit Reports

Good credit is gold. Without it, you have access to your money only. With it, you can put other people's money to work for you. Whenever you apply for a loan, the lending institution performs a *credit check* — a background check to make sure that you're not up to your gills in debt, that your income covers expenses, and that you pay your bills on time. They examine your credit history (documented by the three major credit reporting agencies), bank statements, pay stubs, W-2s, tax forms, and other financial records.

TIP

To ensure success at obtaining loans, become proactive in ensuring your credit history remains unblemished. Check your credit report every three months or so, correct any errors, and take steps to improve your credit rating, as instructed in the following sections. No irregularity is too small to correct. (Checking your own credit report doesn't negatively affect your credit score as can too many *credit inquiries* from prospective creditors. Check your credit history regularly, but keep loan and credit card applications to a minimum.)

The following sections show you how to obtain, review, and correct your credit report. We also offer suggestions on how to improve your credit score.

Obtaining free copies of your reports

As of September 1, 2005, the Federal Trade Commission (FTC) mandated each of the three major credit reporting companies provide you with a free credit report once every 12 months (a total of three free credit reports per year). These three major national credit reporting bureaus contain slightly different information about your credit history, or what's called a *credit report* or *credit profile.*

To obtain your free credit report, do one of the following:

- Submit your request online at `www.annualcreditreport.com`.
- Phone in your request by calling toll-free 877-322-8228.
- Download the Annual Credit Report Request Form from `www.annualcreditreport.com` (click the link to request your report through the mail), fill it out, and mail it to Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281.

TIP

Some banks offer free credit reports, so consider checking with your bank or credit union, too.

If you already obtained your three free credit reports this year and want something more recent, you can order a credit report for less than ten bucks from any of the following three credit report agencies:

Credit score stats

Credit reporting agencies rely on one or more statistical models to determine your credit score. One of the most popular models is the Fair Isaac Company (FICO) rating system. The credit company assigns numerical values to particular pieces of data in your credit history, such as the length of your credit history and the various types of interest you're paying. They then plug these numbers into the statistical model, which spits out your credit score. It's basically a numbers game that weighs the data on your credit report in the following manner:

- 35 percent of the score is based on payment history
- 30 percent is based on outstanding debt or how much you currently owe
- 15 percent is based on the length of your credit history or how long you've been borrowing
- 10 percent is based on recent inquiries on your report (whenever a lending institution requests a report)
- 10 percent is based on the types of credit, such as mortgage or credit card interest

- **Equifax:** 800-685-1111 or online at `www.equifax.com`.
- **Experian:** 888-397-3742 or online at `www.experian.com`.
- **TransUnion:** 800-916-8800 or online at `www.transunion.com`.

Financial institutions may not file reports with all three agencies. To obtain a complete credit history, order a three-in-one report that contains data from all three agencies. All three agencies offer these three-in-one reports.

Checking your credit score

To give your credit rating an air of objectivity, credit reporting agencies often assign you a *credit score* that ranges roughly between 300 (you never paid a bill in your life) and 900 (you borrow often, always pay your bills on time, and don't carry any huge balances on your credit cards). A "good" credit score is 700 or above. A "great" credit score is anything higher than 780.

Your credit score determines not only whether you qualify for a loan but also how much you're qualified to borrow and at what interest rate. A high credit score enables you to borrow more and pay less interest on it. A high score can also lower your home and auto insurance rates so keeping a close eye on your score is important.

Although the law requires each credit agency to supply you with one report annually, it doesn't require them to provide your credit score. When you're getting your free report, you can choose to pay extra to include your credit score.

Inspecting your report for problems

When you receive your credit report, inspect it carefully for the following red flags:

- Names that are the same as or similar to yours, but aren't you.
- Relative with the same name; for example, a father (Senior) if you're Junior.
- Addresses of places you've never lived.
- Aliases you've never used, which may indicate that someone else is using your Social Security Number or the credit reporting agency has mixed someone else's data into yours.
- Multiple Social Security Numbers, flagging the possibility that information for someone with the same name has made it into your credit report.
- Wrong date of birth (DOB).
- Credit cards you don't have.
- Loans you haven't taken out.
- Records of unpaid bills that you either know you paid or have good reason for not paying.
- Records of delinquent payments that weren't delinquent or you have a good excuse for not paying on time.
- Inquiries from companies with whom you've never done business. (When you apply for a loan, the lender typically runs an *inquiry* on your credit report, and that shows up on the report.)

An address of a place you've never lived or records of accounts, loans, and credit cards you never had may be a sign that somebody has stolen your identity. Yikes! Contact the credit reporting company immediately and request that a fraud alert be placed on your credit report. For tips on protecting yourself against identity theft and recovering from it, check out *Preventing Identity Theft For Dummies* by Michael J. Arata, Jr. (Wiley).

Repairing your credit and boosting your score

If you have a credit score of 700 or higher, pat yourself on the back. You're above average and certainly qualified to borrow big bucks at the lowest available rates. Anything below about 680 sounds the warning sirens that you need to dispute errors on your report or repair your credit as quickly as possible. This number is the point at which lending institutions get out their magnifying glasses and begin raising rates and denying credit.

TIP

If your credit rating dips below 700, take steps to improve it, such as the following:

- **Dispute any erroneous items on your credit report.** Disputing a claim doesn't always result in a correction, but you can add a paragraph to your report explaining your side of the story.
- **Apply for fewer loans and credit cards.** When you apply for a loan or credit card, the lending institution typically orders an inquiry that shows up on your credit report. Evidence that you're applying for several loans or credit cards in a short period of time can make you appear financially desperate.
- **Pay off your credit card balances, if possible, or at least enough so the balance is 50 percent or below your available credit limit.** Doing so shows that your credit isn't maxed out.

WARNING!

Paying off high-interest credit card balances is always a good idea, but don't start consolidating loans and closing out accounts. Having four open accounts with a balance of $1,000 each on a $5,000 credit limit looks better than one account with a credit limit of $5,000 and a $4,000 balance. Why? Because of something called *credit utilization* — your total debt relative to the amount of credit available to you. Keeping your credit utilization below 80 percent (preferably below 60 percent) improves your score.

Avoid credit enhancement companies on the Web that claim to provide seasoned credit within 90 days. Law enforcement authorities are shutting down these sites on a regular basis. Legitimate credit counselors can help you repair your damaged credit, but it takes some work and a little belt-tightening. Quick fixes are typically fraudulent fixes. For additional tips on boosting your credit score, check out *Credit Repair Kit For Dummies,* 2nd Edition, by Steve Bucci (Wiley).

Avoiding mistakes that can sabotage your loan approval

After you apply for a loan, resist the urge to make any life-changing decisions that negatively affect your current financial status. Major changes can undermine your efforts to secure a loan, so follow these sage do's and don'ts:

- **Do stay married:** Divorce drains your emotions, energy, and finances. It cuts your assets in half and increases your liabilities, obliterating your chances of securing a loan.
- **Don't apply for other loans or credit cards:** Any last-minute inquiries that pop up on your credit report can be a red flag that cautions prospective lenders.
- **Do avoid buying big-ticket items:** Buying an expensive vehicle can sink a deal. If you must have the vehicle, buy, fix, and sell the investment property first, and then purchase the vehicle with your profit.
- **Don't make any major purchases on credit:** This advice goes for a car, furniture, health club membership, big-screen TV, and any other purchase that can throw off your debt-to-income ratio (see "Calculating your debt ratio" later in this chapter).
- **Don't cosign for any loans:** No matter what your relationship with the borrower is (or how badly your son, daughter, or long-lost uncle needs the money), don't cosign a loan. Doing so exposes your credit history to potential blemishes when others fail to make their payments.
- **Don't withdraw or move substantial amounts of cash:** If a prospective lender looks at an account expecting to see $10,000, and it shows a $50 balance, you have some explaining to do.
- **Do pay your bills on time:** Records of unpaid bills and delinquent payments can get back to prospective lenders. If you have a stack of unpaid bills, pay them now. If a bill is due on the 1st and you pay it on the 15th, you can avoid the late fee. Paying it before the 30th typically keeps the late payment off your credit report. But any bill payment after the due date is considered late and qualifies as *slow pay,* which lenders can figure into their formula assuming they know about it.

If your financial situation changes between the application and the time of closing, you're legally obligated to inform the loan officer and lender of the change.

Chasing Down Vital Paperwork

You can approach a loan application in one of two ways: Either show up with all the paperwork, facts, and figures in hand or consult with a lender first and find out what she needs. The first approach is best, because it demonstrates to lenders that you're well organized and are committed to providing them with everything they need to do their job.

However, in order to come prepared to your lender, you must know which paperwork you need for the meeting. In the following sections, we reveal the information and documentation most lenders are going to require to process your loan application.

Delving into your personal financial information

Unless you plan to borrow money solely against business assets, lenders are going to want to know everything about your personal finances — the value of everything you own, the total you already owe on other loans and credit cards, your monthly and annual income, monthly bills, and so on. And they'll want documentation to back up all those figures.

The following sections show you how to calculate some of these important figures, including your net worth and debt ratio, and list the documentation required to prove the amount of cash you have and the monthly and annual income you earn.

Calculating your net worth

Most people in real estate and banking know their own net worth. Asking folks in these circles, "What's your net worth?" is about as natural as asking them their name. When we ask most consumers to estimate their net worth, however, they look puzzled, as if we had asked them for the square root of pi. They simply have better things to entertain themselves.

REMEMBER

Net worth is simply whatever money you would have if you sold all your stuff and then paid off all your debts, including your taxes. Officially, the equation goes like this:

Net Worth = Assets – Liabilities

A strong positive net worth indicates that you

- Own more than you owe
- Don't borrow more than you can afford to pay back
- Can pay off a loan by liquidating assets, if needed
- Pay your taxes on time
- Probably know more about net worth than you realize

TIP

To prove to a lender that you're net worthy, follow these simple steps to calculate your net worth:

1. **Jot down a list of your assets and liabilities.**

   The tough part is identifying assets and liabilities. Following these steps are lists of common assets and liabilities, which can help you identify yours.

2. **Total your assets.**

3. **Subtract your liabilities.**

   The next time someone asks, "What's your net worth?" you're prepared to answer.

The following lists of items may stimulate your brain cells and help you identify different examples of assets and liabilities.

- **Home:** If you sold your home today, what could you get for it? If you recently had an appraisal, use that number, assuming the appraiser assigned it an honest value.
- **Other real estate:** If you have a vacation home or other real estate, consider how much you could get for it if you sold it today.
- **Car:** The blue book value (current value), not what you paid for it.
- **Savings account:** Whether you have $5 or $50,000, it counts.
- **Checking account:** The current balance as recorded in your check register. No cheating. If you just wrote five checks that haven't cleared yet, you don't really have that money.
- **Retirement savings:** 401(k), IRA, SEP, or other account that you don't dip into for your daily living expenses.
- **Investments:** Stocks, bonds, and mutual funds that aren't part of a retirement account.
- **Jewelry, antiques, and artwork:** If you're not sure what this stuff is worth, have it professionally appraised. People often think that their stuff is worth much more than it really is.
- **Furniture:** If you sold all your furniture at an auction or garage sale, what could you get for it?

- **Cash value of life insurance:** If you have term life insurance, it's worth $0. If you use a life insurance policy as an investment, how much is it worth today?

WARNING!

If you don't have it, don't count it. The money you stand to inherit when Aunt Millie kicks the bucket doesn't count.

Now for the painful part — liabilities. These are items such as the following:

- **Mortgage principal:** The amount you owe on your house today and on any other loans you've taken out on the house.
- **Car loan:** How much would paying off your car loan today cost? Write it down.
- **Student loans:** If you're paying off any student loans from your old college days or are named as a cosigner on any of your kids' student loans, record the amounts as liabilities.
- **Credit card debt:** Dig out your credit card bills and tally up the total you currently owe on them.
- **Taxes owed:** Do you owe any back taxes or property taxes? Total the amount.
- **Personal loans:** Did you borrow $5 from the neighbor to buy candy from the neighborhood kids? Write it down.

TIP

You may be able to obtain most of the liability information you need from your credit report, as discussed earlier in this chapter in the section "Examining Your Credit Reports." However, if you know that you have a debt that doesn't appear on the credit report, be sure to include it in your calculations.

Calculating your debt ratio

Almost every lender examines your debt ratio, so you should know what it is before the topic ever comes up. Your *debt ratio* is how much you pay out in monthly bills compared to your gross monthly income. Generally speaking, you can estimate your debt ratio by dividing your total monthly payments (on loans and credit cards) by your total monthly income:

Debt Ratio = Total Monthly Payments ÷ Total Monthly Income

REMEMBER

Your total monthly payments apply only to payments on loans and credit card balances, not for other expenses like groceries, gas, or clothing. They include payments on long-term debts, such as a car loan or student loan payments, alimony, child support, or a balance you carry on one or more credit cards. Debt ratios come in two flavors:

- **Back-end debt ratio:** The *back-end ratio* consists of your total debt payments (including your house payment with homeowner's insurance and property taxes) divided by your monthly income. According to the Federal Housing Authority (FHA), your back-end debt ratio should not exceed 43 percent.
- **Front-end debt ratio:** The *front-end debt ratio* (also called the *housing ratio*) consists of your house payment alone (including property taxes and insurance) divided by your total monthly income. According to the FHA, your front-end debt ratio should not exceed 31 percent. If your total gross household income is $6,000 per month, for example, your house payment alone should not exceed $1,860.

Gathering bank statements

Almost all lenders are going to ask for copies of the most recent two months' bank statements, so they can see how much cash you have in savings and checking, determine whether you have a healthy cash flow, and check for any activity that looks out of the ordinary (such as large deposits or withdrawals that can't be explained by other documentation). Make a copy of your two most recent bank statements — whether you receive statements monthly or quarterly.

TIP

On the copies, take a black magic marker and mark out the account numbers to prevent others from gaining unauthorized access to your accounts.

Tracking down your pay stubs and W-2s

If you work a regular job, you probably get a paycheck every week or two that shows your gross pay, your deductions (state and federal income tax, Social Security, and so on), and what's left — your *net pay.* Most lenders want a full month (30 days' worth) of consecutive paycheck stubs — not one from last week and another from two months ago; they need to be the most recent and consecutive. They should also show your year-to-date (YTD) earnings.

Most lenders also want to see proof of previous years' income. Of course, they can obtain this evidence by looking at your previous two years of federal income tax returns, but many lenders also like to see your W-2 forms, so be sure to make copies of these as well.

If you don't have a regular job, skip ahead to the section "Accounting for business income" to find out which records you need to supply to prove your business income.

Gathering tax returns and schedules

Every lender requires you to submit along with your loan application your federal income tax returns. Make sure you provide copies of your two most recent federal income tax returns. Copy the complete federal tax return, including all schedules and attachments, not just the first two pages of the return. Include *everything* — don't leave something out just because you don't think it's relevant.

You don't need to supply your state income tax returns unless state grants or subsidies are involved in the transaction or financing.

Pulling up other useful documents

If you follow the instructions in the previous sections, you now have all the major facts, figures, and documentation you need related to your personal finances. However, additional documentation may also be useful (and necessary) in determining whether you qualify for a particular loan. Your lender or broker may need the following:

- Any documents that support your income, such as employment contracts with step increases; union benefit agreements; notes receivable; real estate earnings; earnings from trusts, estates, or settlements; or documentation showing major lottery winnings.
- Property income, including GAI (Gross Annual Income) from rents; storage fees; fees for facilities, such as clubhouse, pools, satellite TV, cable, laundry, or Internet; parking or carport fees; pet income; income from signage; a percentage of tenant sales (for retail commercial properties); and so on.
- Documentation of any unusual liabilities (or the exclusion of them), such as major reimbursed business expenses, personally guaranteed business loans (appearing on your credit report), or old loans that you've paid off but that haven't cleared from your report.

Create copies of any documentation that supports your claims of assets, liabilities, and income. Prospective lenders may request specific documents, but gathering everything you have available in advance makes your job that much easier later on.

Accounting for business income

If you don't have a regular job or you have income (or losses) from a business, you need to supply proof of your income or loss:

- Some of this documentation may already be included in your federal income tax returns. Be sure to include *all* schedules (C's E's, K-1's, and so on) so that the lender has an accurate picture of each of your investments and business holdings.
- If you own 25 percent or more of any company, corporation, or LLC, provide copies of each entity's federal returns for the past two years.
- To provide more recent data, produce a report showing YTD income and expenses for the business. You can produce such reports fairly easily by using a business or personal finance program, such as Quicken or QuickBooks. If you have an accountant, ask the accountant to produce a report for you.

Documenting the property you plan to purchase

Your gut feeling that a particular property is a great investment may be enough to convince you to sign a purchase agreement, but it's rarely enough to convince lenders to finance the purchase. You need to have a plan in place for how you're going to profit from the investment, complete with fairly realistic estimates concerning the costs and revenue potential.

REMEMBER

Many novice investors view the loan application process as a big hassle that just gets in the way of their vision and profits. However, by forcing you to think ahead, the process actually protects you from making bad investment decisions. As an investor, you should only purchase a property to make money or create future wealth, and you should be able to show how an investment will further those goals before you ever sign a purchase agreement.

In the following sections, we show you how to estimate and document the profit potential for investment properties.

Obtaining an appraisal or comparative market analysis

As a real estate investor, your goal is to discover properties that are likely to generate profits. Basically you don't want to pay more for the property than it's worth. To help in your calculations, get your hands on a *comparative market analysis* or appraisal. Your real estate agent can provide you with a comparative market analysis that shows the probable value of the property in relation to similar properties that have sold recently or are currently on the market.

You want to keep your eyes open for property that's likely to make you profits in one or both of the following two ways:

- **Income from sale:** You're looking to buy low and sell high or legally "flip" the property. For more about flipping properties, check out *Flipping Houses For Dummies.*
- **Rental income:** You're planning a *buy-and-hold* strategy, in which your rental income covers (or more than covers) your expenses until you decide to sell the property (hopefully for more than you paid for it).

If you want something more formal and more detailed, you may consider hiring an appraiser. A qualified appraiser can evaluate the market value of the property (to assist in estimating your potential income from selling it) or evaluate the income of the property by using a Net Operating Income (NOI) formula (see Chapter 8).

When you're just checking out some properties, bringing in an appraiser may be premature (and an unnecessary expense). Most investors rely on their own market knowledge and perhaps their agents' insight to estimate the property's value. The appraiser enters the picture just prior to closing to confirm that the property is worth the price you're paying. However, if you're seriously considering a property and are questioning your instincts, you may want to hire an appraiser for a second opinion before moving forward.

TIP

The seller whose property you're thinking of buying may already have had an appraisal done, in which case, you may be able to review it just by asking. (Don't place blind faith in the seller's appraisal — use it only to confirm or question your own evaluation.)

Looking ahead to potential resale value and repair costs

When you obtain an appraisal, the appraiser usually takes into account the property's current condition. If you plan to flip the property for a quick profit, estimate the market value of the property after repairs. What's a realistic price you think you can get for the property after fixing it up? Your real estate agent should be able to help you come up with a realistic value.

You also need to estimate your total costs for the project, including the cost of repairs and renovations, holding costs for the duration of the project (the total you plan to spend on loan interest, property taxes, loan interest, and utilities), and the cost of selling the property (any real estate agent commissions and closing fees).

WARNING!

Overestimate costs and underestimate the final sale price, so you have a bit of a buffer. For details about making well-calculated investments when flipping properties, check out *Flipping Houses For Dummies* by none other than Ralph and Joe, two of your esteemed authors (Wiley).

TIP

If you're planning on holding the property for several years rather than doing a quick flip, you still need to consider the potential future value of the property. For example, if you're buying into a neighborhood where home values are on the rise, then paying close to the appraised value of the property may make sense. The question you need to answer is this: How likely is it that I will more than recoup my investment when I finally decide to sell the property?

Performing a quick cash flow analysis

One of the best ways to build wealth in real estate is to purchase property and hold it indefinitely. During the time you hold the property, you profit in three ways:

- The property appreciates, gaining in value.
- Renters pay down your *principal* (the amount you owe on the property).
- You get a tax write-off for any expenses you incur relating to the rental property.

Of course, your profit hinges on the assumption that you earn more in rent than the property costs you in expenses (including taxes, insurance, landlord-paid utilities, repairs, and improvements). In short, you (and your lenders) want to make sure that that your investment delivers a positive cash flow so you're not losing money.

The formulas for calculating cash flow (or NOI) are fairly basic:

$$\text{GAI} - \text{VAC} = \text{EGI}$$

$$\text{EGI} - \text{TOE} = \text{NOI}$$

If those formulas look like Greek to you, read on:

- **GAI** is your Gross Annual Income; simply calculate your yearly income from all possible sources (rent, carport, laundry, storage, parking, and so on).
- **VAC** is a vacancy allowance; use a minimum of 5 percent of the GAI to allow for vacancy (periods when you have no renters).
- **EGI** is your Effective Gross Income — the total workable revenue you see from the property. Another way of looking at it is that this is the amount of money you have on hand to cover your property's expenses.
- **TOE** represents your Total Operating Expenses; this figure includes all the costs to operate the property, except the loan payments. It includes maintenance, taxes, insurance,

management, landscaping, landlord-paid utilities, office expenses, and so on.

- **NOI** is your Net Operating Income; this number represents your profit on a yearly basis, assuming you pay *cash* for the property.

This formula works for *all* buy-and-hold properties. It shows you and your lenders how much you can afford to pay monthly for the financing. We look at calculating those numbers in Chapter 8.

Calculating the loan-to-value (LTV) ratio

The *loan-to-value (LTV) ratio* is a mathematic representation of how much you owe on your home compared to its appraised value. Banks use LTVs to justify lending money to high-risk borrowers. Even if you have a low credit score and a history of paying your bills a little late, a bank may be willing to cut you some slack and approve your loan if your LTV ratio is low. In other words, the more equity you have in your home, the more likely the bank will approve your loan.

For example, if your home appraises for $250,000 and you owe $200,000 on it, the LTV is $200,000 ÷ $250,000, or 80 percent. Anything below 80 percent is considered great and often qualifies you to borrow more money at a lower interest rate.

Be realistic and know how much you can really afford to borrow. Don't cause yourself stress and future problems by trying to stretch your finances too thin. If after you do your calculations it looks as though you can't afford to borrow more money, don't. Check out some of your other options instead, as we explain in Part IV.

Obtaining zoning information

Most counties or cities zone properties for specific uses, usually to keep businesses out of residential districts or vice versa. Before you purchase a property, find out how it's zoned so you know about anything that could restrict the way you use the property. Check with the local city or county assessment or building inspection office regarding the following:

- How the property is currently zoned
- Any plans to change the zoning for this area
- Whether your intended use of the property fits the current and any new zoning restrictions
- Whether the property is subject to changes in zoning requirements; some properties have "grandfather" clauses that allow

them to operate without being subject to changes in the zoning requirements, but these clauses may expire when ownership of a property changes

Pulling city and county records

When you're investing in real estate, knowledge is power; the more you know about a property before you buy it, the less likely you are to encounter nasty surprises later. The info you gather may also improve your chances of obtaining financing to purchase and restore the property. One way to obtain additional information is to research the public records.

Call the city or county assessor's office or the County Real Estate Mapping Division (every county has one) and find out how to access the parcel maps, aerial maps, tax records, building records, zoning or building appeals, violations, and ownership records. The county has to make all these documents available to the public. Many cities and townships post their records and even property histories online.

If you notice any red flags in the property records, such as a building code violation, address them before you purchase the property and they become *your* headache. In many cases, liabilities for violations and/or discrepancies (such as boundary lines, easements, *riparian rights* [relating to a body of water], natural resource claims, and so on) reach back to only a certain number of previous owners. You don't want to get stuck on the hook for someone else's problem from long ago.

Zoning fiasco

If you think that zoning restrictions are something you can deal with later, think again — they may just deal with you later. Several years ago, I (Chip) bought a property without thinking too much about zoning restrictions and grandfather clauses. I planned to use the property pretty much the same way the owner before me used it. Because no grandfather clause was in place that would expire when I took ownership, I figured I was safe.

Unfortunately, a different type of grandfather clause was in place — one I hadn't considered. The clause stated that if the property burned down, *nothing* could be built in its place. The lot would have to remain vacant regardless of how it was zoned!

Fortunately, the building didn't burn down when I owned it, but getting insurance was tough, and I was severely limited in what I could do with the property. It was zoned for multifamily, but I had to convert it back to single family to get the Certificate of Occupancy that's required before you can lease the property.

The "cleaner" the package, and more documentation you have, the more valuable the property becomes — and the easier to sell later on. Get your ducks in a row early on so that problems don't cause expensive delays later.

Show Me the Money: Identifying Sources of Ready Cash

When you're applying for a loan, the lender will ask you to do one important thing: "Show me the money!" Where will you get the necessary cash for the down payment, the closing costs, the pre-paid items, any repairs or inspections, any third-party fees, or commissions? Do you have sufficient cash reserves to cover unexpected expenses or income shortfalls?

You need to be able explain and document those sources of available cash, as we discuss in the following sections.

Sources of cash for down payments, closing costs, and prepaid items

Although you can usually count on financing the major portion of the purchase price, you probably need to pay some closing costs and other expenses out of pocket. Your lender wants to know up front where the money's going to come from. The money can come from just about any source, as long as you have documentation to prove the money exists:

- Checking and savings accounts
- Retirement accounts
- Money from the sale of other properties
- Refinancing or selling other assets
- Commissions
- Bonuses
- Gifts
- New loans

REMEMBER

Documentation can include bank or other financial statements, sales receipts, HUD-1's from the sale/refinance of real estate, loan agreements, and credit card statements.

Rainy day funds: Cash reserves

On most transactions, lenders want to know you have *reserves* — cash set aside to cover the cost of unpleasant surprises. Simple transactions may require two to three months' cash reserves of the monthly payment or principal, interest, taxes, and insurance (PITI). More-complex transactions may require reserves for construction allowances, credit losses, tenant improvements, and replacement reserves (for example, for new refrigerators or stoves in apartment units). The lender establishes the reserve requirements, and different lenders have different guidelines for calculating minimum reserves.

TIP

The more reserves you have, the better. Even shaky loans get approved based on a borrower having strong reserves.

Getting Prequalified or Preapproved

You're always in a stronger position to purchase a property at an attractive price if you have cash or financing in place when making your offer. Cash is king. Financing is queen. Having to secure financing is about a *2*. Because you're reading a book on financing, we can safely assume that, like most investors, you don't have enough cash on hand to purchase investment properties. The next best option is to prequalify or obtain preapproval for a loan:

- **Prequalification:** *Prequalification* means a lender or broker has reviewed your financial records and determined that you would probably qualify for a particular loan. The lender performs some basic calculations to determine whether your front-end and back-end debt ratios meet the FHA qualification requirements.
- **Preapproval:** *Preapproval* is a more formal, final step in which the lender obtains all the borrower's documentation and underwrites the loan — without a property. With preapproval, the lender agrees to finance the purchase of an investment property up to a certain amount. As long as the property complies with the lender's standards, the loan is a done deal.

REMEMBER

Gaining preapproval puts you in a much stronger position to negotiate. To the seller, it's almost as good as cash. Preapproval is also much better for you as a borrower because it insulates you from changing market conditions. You can move quickly on a property and lock in an approval even if credit tightens and interest rates rise. (Chapter 7 leads you through the loan process so you can do everything necessary to obtain preapproval.)

Chapter 4

Scoping Out Prospective Lenders

In This Chapter

- Hitting up banks for a loan
- Getting a broker to do your legwork
- Exploring the private sector
- Financing through the seller or your Uncle Sam
- Joining forces with a cash-endowed partner

To pursue your dream of owning some investment property, you need some start-up cash. Sure, you can shake all the money out of your piggy bank and cookie jar, but that probably won't score you enough cash to finance your first major acquisition. You need serious cash — probably at least 100 grand — and you don't want to have to go through the neighborhood loan shark to get it.

If you haven't shopped for money before, you may have the misconception that the answer is simple — just head down to the bank. But as we reveal in this chapter, you have many more options from which to choose. If the bank won't loan you the money or offer you a decent deal, maybe someone else will.

In this chapter, we introduce you to the money lenders, including bankers, brokers, and some less-conventional sorts. You may be surprised at the variety available. In later chapters, we get into the nitty-gritty of actually asking for the money.

Borrowing Directly from Banks

You don't need a treasure map to locate huge stores of cash. At just about every major intersection in every town or city, you can find a bank chock-full of greenbacks. Unfortunately, depending on market conditions, your friendly neighborhood bank may not be as eager as you might expect to give you the combination to the vault.

But is a bank the best place to go for a loan? Maybe, maybe not. In the following sections, we weigh the pros and cons of financing through a bank and examine the types of loans banks typically offer. After reading through these sections, you should have a pretty clear idea of what banks can and can't do for you as an investor.

Weighing the pros and cons

Financing your investments through a bank, particularly the bank you use to manage your personal finances, may seem like the perfect solution, at first. It's probably convenient, you already know some of the people, and you feel comfortable doing business with them.

REMEMBER

Don't dismiss any source of financing without first exploring it. Before you head down to your bank to apply for a loan, however, weigh the pros and cons of borrowing from a bank. You may discover that a bank is the perfect solution for your financing needs or that the perfect solution isn't so ideal after all.

Pros

Financing your real estate investments through a bank, especially a local bank, offers several perks, including the following:

- **Security and reliability:** Federally insured banks are generally dependable institutions, although even the most solid institutions are vulnerable to bankruptcy.
- **Convenience:** Banks typically have many branches, which can give you access to convenient locations when you need assistance or a quick draw from a line of credit to act on an investment opportunity.
- **Portfolio lending:** Smaller financial institutions, including banks and credit unions, may be more open to holding loans in their own portfolios rather than selling them to bigger banks or mortgage companies. This allows them to be more flexible on interest and terms. However, portfolio lending is usually available only for short-term (less than three years) loans.
- **Community Reinvestment Act (CRA) goals:** Banks may be required by federal law to lend money for certain projects (including residential and commercial properties) within their immediate geographical area. A lucrative rehabilitation investment project can get the green light just because of the bank's CRA requirements. (For more about the CRA option, check out Chapter 9.)

- **Insights and guidance:** Local banks understand the local real estate market. They're aware of trends and market conditions, and can provide a great deal of insight into the viability of an investment property in a specific area. Your banker may just develop into your own personal real estate investment advisor.
- **Preferential treatment:** Although the world may seem to be becoming more impersonal, relationships still count, especially when dealing with money. As you develop a relationship with people at the bank, especially loan officers and executives, you place yourself in a stronger position to negotiate more affordable loans.
- **Improved access to REO properties:** When a bank forecloses on a mortgage, it often takes possession of the foreclosure property and transfers it to its Real Estate Owned (REO) department, which then tries to sell the property. If everyone at the bank knows you as a trustworthy investor, you may have a better chance of obtaining good deals on these properties.

TIP

During economic slowdowns, when credit usually tightens, REO (or bank-owned) properties become more available. In addition, because banks get stuck holding so many of these properties, they're often willing to finance purchases. Through careful negotiations, you can not only buy properties at great prices but also have the bank finance them. For more about this strategy, check out Chapter 17.

Cons

Although banks offer a host of valuable benefits, they also come with a few drawbacks, including the following:

- **Limited financing options:** Unlike brokers, banks don't help you shop for loans. They can offer you the loan programs from their own menu only. They may not even offer certain loans (such as government loans) for particular types of properties. A *mortgage broker* can provide more options by working with dozens of banks. Check out "Dealing with a Middleman (or Woman): Brokers" later in this chapter.
- **Possible complications:** Many banks *broker* their loans out (sell them to other lenders or institutions), so you end up dealing with another lender anyway without reaping any of the benefits of working through a broker, such as a faster, hassle-free closing.
- **Possible loan processing delays:** Many banks rely on hourly employees to handle loan transactions. As a result, they have no financial incentive to wrap things up quickly. Mortgage brokers, on the other hand, are paid only when the loan closes. They're typically paid on a straight commission for producing the loan, so they have an added incentive to see that it closes quickly.

Mortgage broker or loan officer?

You're likely to hear plenty of industry lingo bandied about, but the first two terms you need to sort out are "mortgage broker" and "loan officer." A *mortgage broker* is a licensed company or professional who assists clients in finding and arranging financing through lenders. Brokers are regulated by the state. A *loan officer* may simply be an individual who works on behalf of a licensed lender or mortgage broker to facilitate the process. Some states license the individual loan officers as brokers.

For all practical purposes, a loan officer offers the same services as a mortgage broker but is required by law to work for the licensed broker or lender. It's sort of like going into your doctor's office and seeing a nurse practitioner — sometimes the practitioner offers better advice than the doctor even though the practitioner isn't licensed to practice medicine.

Of course, you're usually better off working directly with an experienced broker, but if you find a great loan officer, you may do just as well or better.

Conventional loans

Banks typically deal in loans that are considered *conventional* or *conforming* — meaning the loan conforms to all the requirements of Fannie Mae and Freddie Mac (see the nearby sidebar).

Conventional loans are the bread and butter of residential real estate financing, particularly for homeowners but also for investors. With conventional loans, you can always be sure that

- Capital is available.
- Loan costs and interest rates are generally attractive.
- Interest rates among lenders vary only slightly because the money is coming from Wall Street through Fannie and Freddie.

Because conventional loans are primarily intended for consumers borrowing money to purchase a home, plenty of information is available on how to find the best deals on conventional mortgages. For more information, we recommend *Mortgages For Dummies,* 3rd Edition, by Eric Tyson and Ray Brown (Wiley). To separate mortgage fact from fiction, check out our book *Mortgage Myths: 77 Secrets That Will Save You Thousands on Home Financing* (Wiley).

REMEMBER

Conventional loans are also available for investors, although they tend to cost more and be more restrictive — with a loan-to-value) usually no higher than 75 percent and 1 to 1.5 points. (For more about LTV, see Chapter 3. For information about points, refer to

Chapter 6.) As an investor, keep in mind that having access to cash is often more important than the cost of gaining access.

Subprime (nonconforming) loans

Subprime loans (also known as *nonconforming loans*), are the bad boys of the mortgage lending industry. At least that's what many people were led to believe during the great mortgage meltdown in the late 2000s. Due to some irresponsible underwriting by lenders and irresponsible borrowing on the part of consumers, subprime loans did contribute to the mortgage meltdown, but that doesn't make them all bad. They do serve a useful purpose when used appropriately.

Subprime loans are everything that Fannie Mae and Freddie Mac aren't. Although some subprime loans known as Alt-A loans can go through Fannie and Freddie, most don't. (An *Alt-A loan* or *alternative A-paper* loan is one for which the approval is based primarily on the borrower's lower credit score, or other situations such as self-employment, that increase the risk of repayment.) Instead, subprime loans are usually available through other institutional investors, pension funds, insurance companies, various large and small mortgage banking firms, and even individuals.

Fannie and Freddie who?

The question is more like "Fannie and Freddie what?" Fannie Mae is actually a nickname for the FNMA, or Federal National Mortgage Association. Freddie Mac is a nickname for FHLMC, or Federal Home Loan Mortgage Corporation.

Both organizations do pretty much the same thing — they purchase residential mortgages and then convert the mortgages into securities for sale to Wall Street investors, indirectly financing the purchase of homes. In other words, they sort of act as the middlemen between banks and Wall Street investors. The end result is that they make money readily available for the purchase of homes and other real estate.

Although both institutions began as government-chartered, private companies, they're now controlled by the government as a result of the problems they ran into during the mortgage meltdown that started in 2008. While we were writing this book, it was still too early to tell whether the end result would be a consolidation, merger, or something else entirely, but whatever happens, Fannie and Freddie should essentially function the same way but with more restrictions.

Instead of Fannie and Freddie setting the qualifications for these loans, the market and individual investors lay down the rules and decide what's available and to whom. As a result, they can offer a much greater variety of loan packages that appeal to niche markets and address specific needs, such as the following:

- Limited-documentation loans make it easier for investors who don't have the necessary financial documents (tax returns, pay check stubs, and W-2s) to qualify for loans.
- Hybrid adjustable rate loans can help investors with short-term financing and cash flow by providing flexibility in interest rates.
- Rehabilitation programs can open doors to investors by funding special projects or development in certain areas.

Subprime loans have some drawbacks, particularly if the borrower doesn't fully understand the terms, which can be complicated. When shopping for any loan, make sure you're working with a qualified and trustworthy professional who can clearly explain your options and the ramifications of choosing a particular option. In short, know what you're getting into before signing on the dotted line.

One of the main drawbacks of subprime mortgages is that certain programs can disappear overnight as the appetites of Wall Street investors and consumers change. Numerous creative subprime loan packages emerged leading up to the mortgage meltdown, and many of these options disappeared as soon as loan defaults shot up.

Dealing with a Middleman (or Woman): Mortgage Brokers

A *mortgage broker* is sort of like a real estate agent, but instead of helping you find the right house, the broker helps you find the right loan. Ideally, a broker sits down with you to determine what you're planning on using the money for and then assists you in selecting the lender and loan package that best meets your needs. Through a broker, you gain access to dozens of financing options as opposed to the limited few you may find with a local bank.

In the following sections, we discuss the pros and cons of working through a broker and then show you how to find brokers and research their credentials and references.

Weighing the pros and cons

As you probably already guessed, we think that most investors can benefit by shopping for loans through a broker — a good broker, that is. In the following sections, we list the reasons why. To give a balanced perspective, we also list a couple of reasons why you may not want to use a broker. Furthermore we give you clues to uncovering a good broker and what you can do to verify the broker is reputable and the right choice for you.

Pros

Mortgage brokers offer a host of benefits for fueling your real estate purchases and development, including the following:

- **Better selection:** A broker has access to many different lenders, each of whom may offer several different loan packages, so you're more likely to find a loan that meets your unique needs.
- **Bargaining power:** Mortgage brokers can negotiate fees and terms with large lenders and play one off the other to negotiate the best deal on your behalf.
- **Marketplace knowledge:** Brokers are more in tune with new and creative financing programs and options. When new programs become available, they're often the first to know.

TIP

Although mortgage brokers specialize in the mortgage lending industry, many are also very knowledgeable about the real estate market in their area. In addition, a well-established broker is likely to have connections with other investors, local bankers, real estate attorneys, and so forth. Take full advantage of what your broker has to offer.

Cons

Mortgage brokers are sort of like doctors and lawyers — if you find the right one, you have no reason not to use a broker. However, finding and keeping a qualified broker who's dedicated to serving your needs can be quite a challenge. Watch out for the following:

- **Lack of experience:** Many brokers may not be experienced enough or large enough to deal with the right lenders. You can spend a lot of time researching and checking credentials and references before you find a great broker.
- **High turnover:** Brokers can disappear overnight. Becoming a broker doesn't require a huge capital investment, so brokers often come and go. After a long search, you may find a top-notch broker only to discover that several months later the person is no longer in business. You may end up losing time, money, and a valuable resource.

Shaking the branches for a broker

Although you can certainly flip through the "Mortgages" section of the phone-book ads or search the Internet for "mortgage brokers any town, your state USA" to find brokers in your area, these methods don't focus in on the highest quality prospects. The best way to find qualified, experienced mortgage brokers is to search through the people who actually borrow money to finance their real estate investments — real estate investors.

Obtain referrals from investors in your area, so you know the broker has experience working with investors and has provided satisfactory service to at least one person. Most investors will also tell you which brokers to avoid.

TIP

If you don't know other real estate investors in your area, you have some work to do. Join a reputable real estate investment club such as the Rental Property Owners Association (RPOA) and start networking. (Search the Web for "rental property owners association" followed by your state.) You can pick up plenty of market knowledge just by attending meetings and talking with people who've been there and done that.

Checking a broker's credentials

Ideally, a mortgage broker works on your behalf to find you the best deal. Unfortunately, brokers don't have a *fiduciary* (legal financial) responsibility to you as the borrower. As a result, some brokers may try to sell you on a loan that brings them a higher commission rather than provide you with a better deal. This is why finding a trustworthy broker who has a stellar reputation is so important.

In the following sections, we show you how to do your own background check on mortgage brokers, verify their credentials, and interview the top three candidates.

Doing a background check

After you have a list of possible candidates, start trimming that list to three finalists by doing a background check on each candidate:

- **Check the National Association of Mortgage Brokers (NAMB) Web site at `www.namb.org` to make sure the broker is a member.** NAMB members follow a strict code of ethics, tend to be more dedicated to the profession, and are required to take continuing education courses.

- **Search the Internet for the company's or individual's name.** If the candidate has a bad reputation, dissatisfied clients are likely to post something about it on the Web.
- **If the company or individual has a Web site or blog, visit the site and explore.** Make sure the broker deals in both conventional and subprime loans. The more established brokers also offer government loans, including Federal Housing Authority (FHA) and Veteran's Administration (VA) loans. (Check out the section "Borrowing from Uncle Sam: Government Loan Programs" later in this chapter for these types of loans.)
- **Visit your state's Web site and verify that the broker is licensed in your state.** If you can't find your state's Web site, call the licensing board in your state capital. All 50 states have licensing requirements for mortgage lenders. Some states have licensing for individuals as well. Check for any administrative actions or sanctions, or complaints (many complaints aren't public unless the department of licensing takes action). You may also want to check your state attorney general's Web site.
- **Check the Better Business Bureau (BBB) for any complaints.** Start at the national Web site's home page at (`www.bbb.org`), which can direct you to the Web site for your local branch.
- **Contact your local chamber of commerce to determine whether the broker is a member in good standing.** Being an established member of the local business community is always a big plus.
- **Contact each broker who's made the first cut and obtain three references from investors and three references from real estate agents the broker has worked with.** (Make sure the real estate agents are well-established in the community, not just part-timers.) Call the references and ask about their experience working with the broker.

Don't just go with the broker who has the largest ad in the phone book or the local newspaper. Check their credentials with the state licensing board, the BBB, and the state attorney general's office for complaints and/or regulatory actions or sanctions.

Interviewing the top candidates

After you've chopped your list of candidates down to three, call to set up an interview with each of them. During the interview, be sure to ask the following questions:

- **How long have you been in business?** You're looking for someone who's been a broker for at least a couple of years.
- **How many transactions do you process in a year?** Good brokers average at least 40 to 50 transactions per year. Someone

who processes way fewer than average may lack motivation. A broker who processes way more may not be careful enough.

- **What percentage of your transactions are conventional, non-conventional, and government loans?** Brokers generally deal with far more conventional loans, but look for a broker who has experience with all three types.
- **What percentage of your transactions are investor loans?** Brokers who do a substantial percentage of their business with investors are usually a better choice than those who exclusively serve consumers/homeowners.
- **How many lenders do you work with?** Generally speaking, the more the merrier. The more lenders the broker has access to, the wider the selection of loan packages.
- **What's your specialty?** Just as real estate agents specialize in certain types of homes, mortgage brokers specialize in certain types of loans (such as government loans, first-time home buyers, construction loans, and so on). Choose a broker who specializes in the types of loans that best fit your investment strategy. (See Chapters 5 and 9 for descriptions of different residential and commercial loan types.)
- **What are your application fee requirements?** Determine how much money the mortgage broker charges upfront at the time of application and what those fees are applied toward. Compare costs among the brokers and make sure they're applying any fees to real services rather than pocketing them as extra money.
- **What's your policy on locking in interest rates?** Does locking in a rate cost extra? How long does the rate remain locked? How soon before closing does the rate have to be locked?
- **What's your refund policy for cancelled loan applications?** Some brokers actually charge upfront fees up to $1,000 or more if you cancel a loan application. You're better off knowing about it now than when you need to cancel an application.

TIP

During the interview, make sure you get along with the broker and that your personalities match up pretty well. If this is a good fit, you'll be working together for some time. You want somebody you can get along with.

Taking the Hard-Money Route through Private Lenders

Hard money is called "hard" for a reason — it's hard to get, hard to pay, and generally costs more than your average loan. Hard money comes from individuals or small groups of private investors who like to obtain a high return on their money and are willing to take some additional risk in order to get it.

Because hard money costs more, you may wonder why anyone on earth would even consider it. Just like any other type of investment method, hard money has its upsides and downsides. Hard money offers several benefits:

- **More financing options:** You gain access to cash you may not be able to get through a conventional lender. Hard money loans typically cost more in points upfront and interest, but the terms can be more flexible than with conventional loans.
- **More collateral options:** Hard-money lenders often accept the *future value* (after renovations) of a property as collateral, so you don't have to borrow against other assets, like your home.
- **More flexibility:** You can often close the transaction faster, with less paperwork, and even set up a separate escrow account with a hard money lender to pay for repairs and renovations.
- **Less intrusion into your business:** Banks tend to be more intrusive, wanting more information about the business operation than a hard money investor does. The hard-money lender sets a lower LTV requirement, so you have less equity risk from the start. Even so, hard-money lenders do want to know the plan for repayment and see a business plan if it's contingent on a business tenancy arrangement.

On the flipside, hard money does have a few significant drawbacks:

- **Higher cost:** Sometimes gaining access to cash, whatever the cost, is good investment decision — as long as you account for that cost in your calculations and can still turn the profit you want.
- **Lower ratios:** Another disadvantage of hard-money loans is that the LTV's (loan-to-value ratios) are typically lower. For example, instead of being able to borrow 80 to 90 percent of the value of the property, you may only be able to borrow 65 to 75 percent. However, hard-money lenders are often willing to make the calculations on the future value of the property. For more about using hard money to finance your real estate investments, check out Chapter 11.

TIP

Hard-money lenders may be more willing to negotiate with investors, especially investors who have a solid track record. Some lenders, for instance, may charge three or four points upfront to reduce their exposure to the risk of an early default but then agree to refund one or two points when you've paid off the loan.

Borrowing from Uncle Sam: Government Loan Programs

The housing market plays an important role in driving the economy, so the U.S. government does what it can to support this key industry. One of the primary support mechanisms are government (or government-secured) loans made available to first-time home buyers. If you're like most Americans, you probably used an FHA (Federal Housing Administration) or VA (Veterans Administration) loan to purchase your first home.

Through the FHA, the U.S. Department of Housing and Urban Development (HUD) also offers loans to homeowners and investors to assist in rehabilitating properties. Government loans are designed to help the marketplace in areas where the private sector can't. After Hurricane Katrina, for example, several government programs came to the rescue, encouraging investors to assist in rebuilding the damaged areas. Special grants and state and federal loan programs gave investors access to cash that the banks and private sector wouldn't or couldn't offer.

REMEMBER

In most cases, the government steers clear of lending money directly to homeowners and investors. Instead, the government *secures* the loans. If the borrower fails to pay back the loan, the government steps in, picks up the tab, takes the property, and tries to sell it to recoup its loss. Additionally, most government programs are limited to owner-occupied properties.

As a homeowner, you're already aware of some of the benefits that government-secured loans offer homeowners, but government loans can also benefit investors in two important ways:

- Understanding government loans can enable you to flip the property to a buyer down the road. For example, the *Good Neighbor Next Door loan* (GNND) enables qualified buyers (including teachers, law-enforcement professionals, and firefighters) to purchase certain HUD homes with only a $100 down payment, or even some HUD repo's at half price; *203(k) loans* help an owner rehabilitate a property, pay for additions, and even purchase new appliances. Using the GNND loan and a 203k loan, a qualified investor can actually buy a home for half its market value with a $100 down payment and then sell it several years down the road to earn a handsome profit.
- You may be able to purchase government-owned properties directly (usually those foreclosed on due to nonpayment of an FHA or VA loan) and finance the purchase through the government agency.

For more about using specific government-sponsored loan programs to finance real estate purchases and rehabilitation, see Chapter 5.

Financing through the Seller

Before most homeowners can pack up and move, they have to sell their homes and pay off their current mortgages so they can afford to buy their new homes. Homeowners who've paid off their mortgages or have sufficient cash available, however, don't need the full purchase price upfront. They can sell you the home and *finance* the purchase. In other words, the seller becomes the bank.

If a seller is willing and able, you can often purchase the property on contract through a lease option agreement or a land contract. The contract takes the place of the mortgage document that most buyers sign when they close on a house. In the following sections, we explain how these contracts work. For more about the pros and cons of financing through the seller and the nitty gritty of how to harness the power of seller financing, check out Chapter 12.

Lease options

A *lease option agreement* is sort of a rent-to-own deal. You rent the property from the owner for a fixed period (usually no more than a few years), at the end of which time you have the option to buy the property. Normally, the seller requires some sort of down payment (often less than a typical mortgage lender requires), which should be applied to the purchase price, along with monthly rent equivalent to about 1 percent of the purchase price.

A lease option agreement can be a great way to finance the purchase of an investment property, assuming you're working with a seller who deals aboveboard, and you have a great plan in place for obtaining cash or alternative financing by the time your option to buy the property rolls around.

So how does a lease option work? The monthly payment consists of rent plus some additional money that's applied to the purchase price. In other words, if the going rate for rent on the property is $1,000 per month, you may have a monthly payment of, say, $1,500 with the extra $500 being added to your down payment. This ensures that you're building equity in the property during the lease part of the agreement, and it provides the seller/lender with some security in the event that you back out of the deal.

WARNING!

Make sure that the lease option agreement is *very specific* regarding the application of payments and terms of exercising your option. Otherwise, you may lose a lot of money in rent that you assumed was being applied to the purchase price or lose your option to buy on some minor technicality. Have a qualified real estate attorney look over the agreement before you sign it, and make sure you understand it completely.

Land contracts

With a *land contract* (also called a *contract for deed*), the seller essentially functions as a bank, so you're cutting out the middleman. In most cases, you handle the transaction through a reputable escrow company. The deed is held in escrow, and you make payments to the escrow company. When you've finally paid the loan in full, the escrow company releases the deed to you.

Land contracts are often win-win situations, benefiting both the seller and the investor:

- The seller profits not only from the sale of the property but also from the interest the buyer is paying. They earn investment income generated by an asset they know and love — their own real estate.
- The investor benefits by not having to pay a lot in closing costs and being able to obtain a loan without having to jump through hoops for a bank or mortgage company. With the increased cash flow, an investor can obtain more properties by using this strategy.

WARNING!

Make absolutely sure that payments are handled by a servicing company — *not* by the seller — and that the deed is placed into escrow. The last thing you want is to make payments for seven years, only to find out that the underlying mortgage wasn't paid, the property has a tax lien against it, and the seller is nowhere to be found to sign off on the deed! Been there, done that, not going back for seconds.

Teaming Up with a Cash-Heavy Partner

Successful partnerships begin with individuals whose needs and offerings complement one another — in other words, when one partner has what the other needs, and vice versa. People who have plenty of cash often don't have plenty of time, talent, and motivation to purchase, renovate, and manage real estate, and they really don't have to — they can hire someone else to do it for them. This is where you come in as an investor. You have (or should have) the know-how. All you need is the money.

In the following sections, we introduce you to various ways to structure a partnership that typically work well in real estate. In Chapter 13, we go a little deeper to show you how to partner with the right individual(s).

Opting for a limited partnership

A *limited partnership* is called "limited" for a very good reason — the liability protection (none) and tax benefits (insignificant) of a partnership are very limited. Legal actions against one partner can lead to actions against all partners, and each partner can be held personally liable for actions of the partnership as a group. In other words, if you're going to partner up with someone, you really need to form the partnership inside the protective bubble of a corporation, as discussed in the following section.

Limited partnerships do offer a few benefits. They're

- Easy to set up
- Inexpensive
- Simple to manage for the few involved parties

You can set up a limited partnership with two or more people (including yourself) on a per-property basis or to invest in multiple properties. Just make sure you have all the terms of the partnership *in writing*. The agreement should address the following three areas:

- **Partner responsibilities:** Spell out what each partner is responsible for — supplying capital, finding and buying real estate, making repairs and renovations, marketing and selling the property, and so on.
- **Profit sharing:** Specify how profits from the real estate ventures are going to be split.
- **Dissolution:** Stipulate how you're going to divide any cash and other assets if you decide to dissolve the partnership later. Yeah, we know — when forming a partnership, the last thing you want to think about is the possibility that it will end, but it's better to come to an agreement now when you're friends than later when you're at each others' throats (hopefully, that doesn't happen).

TIP

Have an attorney draw up the partnership agreement and explain the terms to everyone involved. Each partner should have his own legal representation to ensure that his interests are protected.

If you're forming a corporation, a partnership agreement is still very useful in clarifying each partner's responsibilities. If you decide not to use a written agreement, at least make sure that your corporation papers clearly explain how distributions will be applied — usually determined by shareholder percentage of ownership and disclosed on the K-1 (the tax schedule showing the total annual payments, deductions, and credits to the shareholder).

Going the corporation route

Even if you happen to form a partnership with one or more other individuals, managing your partnership as a *corporation* offers additional benefits in terms of taxes and liability protection. You have three options here:

- **LLC:** A limited liability corporation (LLC) limits your exposure to risk. If someone takes legal action against the corporation, your personal assets are protected. For most investors, we recommend forming an LLC, as discussed in Chapter 2.
- **Sub-S corp:** A Sub-S corp (short for Subchapter S corporation) also limits your exposure to risks and allows for pass-through taxation (unlike a C-corp). With *pass-through taxation,* the corporation's profits pass through to your individual income tax return, avoiding *double-taxation* (in which both you and your corporation are taxed). Only individuals, not other business entities, can own a Sub-S corp, and the corporation can have a maximum of 75 shareholders. With a Sub-S, you run the risk of the IRS forcing it into C-corp status (described in the following bullet) if the corporation shows as having too much *passive income* (income you don't really do anything to earn, such as rental income, that's taxed at a lower rate than *earned income*).
- **C-corp:** A C-corp (short for Chapter C corporation) also limits your personal liability, but we don't recommend going the C-corp route for most real estate investors. First, you need to have at least 75 shareholders or establish a real estate investment trust (REIT), as discussed in Chapter 2. A C-corp also exposes you to double-taxation, which can really take a bite out of your profits.

REMEMBER

A Sub-S corporation is simple to establish and file for, but make sure to file for the Sub-S election with the IRS right away after forming the corporation. For more about forming and managing a corporation, check out *Incorporating Your Business For Dummies* by The Company Corporation (Wiley).

Part II

Financing the Purchase of Residential Properties

The 5th Wave By Rich Tennant

"We got a hybrid loan. It starts out as a fixed rate loan, converts into an ARM, and if the lender's not satisfied with his return, we host his in-laws every other summer in the basement."

In this part . . .

When most folks buy a home, they're usually best off to look for a 30-year fixed-rate mortgage that keeps their payments low and steady and allows them to pay off the loan in a reasonable amount of time. When you're financing real estate investments, however, cash flow becomes much more important. You usually want to use as little of your own money as possible, so you have cash on hand to cover other investments and unexpected expenses.

This part gives you the tools to secure the financing you need to start hunting for residential real estate investment opportunities. In this part, we explore the many residential loan programs currently available, show you how to compare different loan packages to find the one that costs the least overall, and lead you through the loan application from filling out the forms to closing.

Chapter 5

Finding the Residential Loan Program That's Right for You

In This Chapter

- Understanding why choosing the right loan is so crucial
- Focusing more on cash flow than on loan costs and interest
- Checking out what your government can do for you
- Dodging prepayment penalties

Consumers have hundreds of different residential loan programs to choose from, including zero-down-payment programs, 40- and 50-year terms, interest-only loans, and complicated adjustable-rate mortgages that can double your payment overnight! In addition, investors may have access to government financing through rehabilitation loans, renaissance loans, and even grants for redevelopment. With so many types of loans and other financing to choose from, how do you pick the type that's best for you as an investor?

This chapter introduces you to the most common residential loan types, explains how each program works, and guides you in choosing the right type of loan for your investment needs.

The market is in constant flux, so new mortgage programs are constantly being introduced while obsolete programs are being phased out. In writing this chapter, we've tried our best to provide information that's detailed enough to be useful, but general enough to accommodate market changes.

Understanding Why Finding the Right Residential Loan Is Key

You're not the only one who wants to earn a buck off real estate. Lenders want to earn their keep, too, so they charge all sorts of interest, fees, and penalties. As an investor working through one of these lenders, you have two primary goals:

- **Gain access to cash.** You need cash to do deals. Check out the following section, “Choosing a Loan Type to Maximize Your Cash Flow” for more information.
- **Pay as little as possible for access to that cash.** After all, the more you pay in interest, fees, and penalties, the less money you walk away with at the end of the day.

In order to meet these two goals, you want to locate the right residential loan. To help you know what’s available, throughout this chapter we roll out a veritable smorgasbord of loan types so you can home in on the type that sounds best for a particular deal. Another key to locating the right loan is to examine *all* the pros and cons of each available loan before making a selection. We cover this important step in Chapter 6.

REMEMBER

When searching for the right residential loan, you also need to know the difference between residential and commercial loans. *Residential* mortgage loans finance the purchase of properties that people live in — single-family homes, multifamily dwellings, apartment buildings, condos, and co-ops. *Commercial* loans finance the purchase of properties that house businesses. With residential loans, lenders typically examine the ability of the *borrower* to make payments and eventually pay back the loan. With commercial properties, lenders give more weight to the *building’s* ability to produce sufficient income. (See Part III for more about financing the purchase of commercial properties.)

Choosing a Loan Type to Maximize Your Cash Flow

When most folks buy a home to live in, the main ingredients they’re looking at in a mortgage loan are interest rate, *term* (number of years to pay off the loan), and monthly payment. They want a monthly mortgage payment they can afford without paying an exorbitant amount of interest over the life of the loan.

As an investor, your needs are different. Your primary goal is to gain access to cash, even if you have to pay more to gain that access. The interest rate, terms, and payment matter only as they relate to your all-important cash flow. As a result, the criteria you use for comparing loans are likely to differ a great deal from the criteria you use to select a mortgage for a primary residence.

We toss the term *cash flow* around quite a bit and even use it as a verb, as in "Wow, this property really cash flows!" So what is cash flow, exactly? *Cash flow* simply means that the property is bringing in more cash than is going out each month. If your property is losing money, it has a negative cash flow . . . and you have problems.

When you're more focused on gaining access to financing than worrying about the cost of financing, your options suddenly multiply. You can begin to consider loans that you would otherwise dismiss outright as costing too much. In addition, you can begin to explore a host of options that aren't available to the average homeowner, such as rehabilitation loans.

In the following sections, we show you how cash flow enables you to leverage the power of using other people's money to finance your investments and introduce you to a few types of loans that can maximize the cash you have available for investments.

The power of OPM (other people's money)

One of the secrets to maximizing your investment profits is to use as little of your own money and as much of other people's money (OPM) as possible. By using OPM, you stretch your investment dollar — you can buy more and better properties and increase your profit potential as a result.

Whenever you finance the purchase of a property, rather than paying cash with your own money, you're using OPM. Throughout this book, we reveal various sources of OPM, including bank loans, government-secured loans, hard-money lenders, small-business loans, and so on. We introduce the concept of OPM here, so you have a better understanding of why you want to borrow money (rather than using all your own money) to purchase real estate. After you grasp the concept of OPM and understand the leverage it gives you, you're better prepared to begin evaluating the sources of OPM.

The magic of using OPM is in the numbers, as the following examples reveal:

- You invest $100,000 cash to buy, renovate, and sell a house for $120,000. You just made a 20 percent profit ($20,000 profit divided by your investment of $100,000 equals 20 percent).
- You invest $20,000, borrowing the other $80,000 to buy, renovate, and sell a house for $120,000. You just made a 100 percent profit ($20,000 profit divided by your investment of $20,000 equals 100 percent).

Did I overpay for that loan?

Several years ago, I (Chip) obtained a mortgage for a two-family duplex at 9.50 percent interest, and paid 3 points to get it. The market rate for mortgages was about 6 percent at the time, and qualified home buyers were usually able to secure a mortgage without paying any points. Most people would have thought I was crazy.

Was I?

Crazy like a fox, maybe. I needed a loan to purchase an investment property, and because the property had been severely neglected and in disrepair, the type of loan I needed wasn't readily available in the marketplace. Without cash, I couldn't do the deal, so I was willing to pay a premium to gain access to the cash I needed. It was just a short-term solution until I could make some repairs to the point that the property became eligible for more-conventional (and less-expensive) financing. But the cash flow made it very attractive (and profitable) — even at the higher interest rate.

When financing real estate investments, you have to remember to stop thinking like an average homeowner and start thinking like an investor. Put your investor cap on when examining the terms and make sure the cash flow works for the property you're planning on buying.

In these examples, you earn five times more profit percentage-wise by using other people's money, even though you earn the same profit in terms of dollar amount. You may argue that you still end up with $20,000 in your pocket either way. But say you have $100,000 to invest, as in the first example. Instead of buying one property with $100,000, you can divvy it up into $20,000 chunks to buy five $100,000 properties (borrowing $80,000 for each). You now control $1,000,000 worth of real estate and when you sell the properties, you earn $20,000 each for a total profit of $100,000!

WARNING!

Borrowing money is always risky, but you have to take some risk. Throughout this book, we show you ways to reduce the risk, but unforeseen events can undermine the best-laid plans. As a real estate investor, you need to decide for yourself whether the potential benefits outweigh the risks.

The following sections reveal some loan types that can free up more of your own money and maximize the use of OPM.

Interest-only mortgages

An *interest-only loan* is just what it sounds like; if you take out an interest-only loan for $100,000, in two years, after making 24 interest-only payments, you still owe $100,000. Sound like a bum deal?

It may be, if you plan on living in your home for 15 years and the value of the home doesn't appreciate significantly. But if you're using the loan for a quick flip, it may be perfect. You pay off the loan in full right after you sell the house. In the meantime, you have more investment capital to put toward renovations or other properties.

WARNING!

The key to using interest-only loans wisely is in making sure the property provides a positive cash flow — enough revenue to more than cover all your costs, including the monthly interest you're paying, and the value of the property is stable or rising. When considering interest-only loans, be aware of the following:

- Most interest-only loans are adjustable rate mortgages (ARMs), so carefully check the adjustment period, index, margin, and cap. (For more about ARMs, check out the following section.)
- Rarely is an interest-only loan interest-only for the life of the loan. Read the fine print to determine when and how you must pay the principle. Some loans require a lump-sum payment three to five years down the road. They suck you in with low monthly payments early and then sock you with huge bills later. This fake-out may be devastating to the average homeowner, but if you know about it and plan for it, an interest-only loan can be your ticket to a profitable investment property.

REMEMBER

Nobody can judge a loan type as good or bad without considering how the investor uses the loan to finance the investment. If a no-interest loan frees up some cash so you can complete the repairs and renovations on a property more quickly, the fact that your entire payment was going only toward interest matters very little.

Grabbing a hold of ARMs

Adjustable rate mortgages (ARMs) have interest rates that fluctuate. You may take out a loan for 5 percent and find yourself paying 8 percent the following year. Even so, ARMs can play a valuable role in your investment strategy. They're often easier to qualify for, and if you can sell the property or refinance the loan before the rate jumps, you may be able to avoid any huge increases in interest and payments.

WARNING!

As was revealed during the great foreclosure crisis that began in 2008, ARMs are risky business for most homeowners. Tight credit can undermine your plans to sell or refinance. In the meantime, your monthly payment increases could make the property unaffordable. Realize that when you take out an ARM, you're taking a gamble. To minimize your exposure to risk, figure out the worst-case scenario and plan accordingly.

When shopping for ARMs, examine the following factors to determine the worst-case scenario:

- **Initial interest rate:** The interest rate when you sign for the loan. This is usually a *teaser* rate to make the initial payments more attractive.
- **Adjustment period:** The frequency at which the rate can go up or down. This is typically one, three, or five years but can also be months rather than years.
- **Index:** ARMs are tied to an *index* that typically rises or falls based on government lending rates. Ask which index the lender uses, how often it changes, and how it has performed in the past. Several indexes are considered standard, including the Treasury index, the London InterBank Offered Rate (LIBOR), the Cost of Funds Index (COFI), the Prime Rate, various T-Bills, and the Fed Funds Rate.

  The Treasury index is always a little safer and secure and is the most common. Take some time to look up whatever index your lender uses, and make sure you can find it in *The Wall Street Journal* (the financial rates section) or a similar publication.
- **Margin:** The percentage above the index that the lender charges — think of it as a markup. For example, if the index is at 3 percent and the margin is 2 percent, you pay 5 percent interest. If the index rises two percentage points to 5 percent, you pay 7 percent interest. The margin remains the same throughout the life of the mortgage.
- **Cap:** The highest interest rate the lender can charge, no matter how high the index rises. So if the lender sets the cap at 9 percent, you never pay more than 9 percent interest, no matter how high the index goes. The lender likely will quote a yearly cap and a lifetime cap as, for example, "2/6", which means the rate can go up 2 percent per year (or per adjustment), and 6 percent over the life of the loan.

Make sure you understand all the possible adjustments that can take place and calculate the payments under a worst-case scenario. Plug this number into your *pro forma* calculations (your projections) to make sure that your property will still cash flow under the worst of circumstances. We can't stress enough the need to do your homework, and possibly consult your highly qualified and trusted mortgage broker before selecting an ARM.

Hybrids

A *hybrid loan* is a combination of an ARM and a fixed-rate loan. With a hybrid term, the interest rate remains fixed for a certain number of years, after which time the rate is adjustable. For example, with a 3/1 hybrid, the interest rate remains fixed for 3 years and then becomes an adjustable-rate loan in which the rate can be adjusted every year. A 2/28 hybrid has a fixed interest rate for the first 2 years and then adjusts each year for the next 28 years.

These types of loans are better suited for situations in which you plan on holding the property for at least a couple of years before selling it and you're fairly certain that interest rates won't drop over the next couple years. If you're planning on selling the property quickly, an adjustable rate mortgage with a low introductory interest rate may be a better choice. (See the previous section for more on adjustable rate mortgages.) On the other hand, if you plan on holding the property for longer than a couple of years, a fixed-rate mortgage may be more appealing.

The main advantage of a hybrid over a straight ARM is that it provides, at least for a time, a guaranteed fixed interest rate, which can help you establish more reliable cash flow projections for the duration of the fixed-interest term. You still need to be careful, however; hybrid loans can turn into time bombs if your projections are based on unrealistic assumptions. An unexpectedly steep jump in the interest rate can quickly create a negative cash flow.

Hard-money loans: Private investors

When *easy* money is unavailable (money from financial institutions), you can always turn to *hard-money lenders* — private investors who offer loans that typically charge several points upfront, use higher-than-average interest rates, and require payment in full after only a few years.

Why would any investor in her right mind even consider a hard-money loan? Because you gotta have cash to do a deal, and sometimes hard money is the only money you can get your hands on. For more about financing your real estate investments with hard money, turn to Chapter 11.

Taking Advantage of Government-Secured Loans

You may be able to hit up your rich Uncle Sam for a loan to finance your real estate investments (refer to Chapter 4 for more on how government loans work). Although the government rarely loans money directly, especially to investors, it often secures loans so lending institutions can make the money available without exposing themselves to huge risks. (If a borrower defaults on a government-secured loan, the government pays the difference and sells the home to recoup at least part of its loss.)

Although many government loans are available only to finance the purchase of *owner-occupied* properties (properties that the borrower/homeowner is going to live in), in some cases you can also use these programs to finance the purchase, repairs, and renovations of investment properties.

In the following sections, we describe a host of government programs that may be available to you depending on your investment strategy and the property you're planning to purchase. We also show you how to go about tapping into these government-sponsored resources.

Tapping the FHA for a loan

Although the Federal Housing Authority (FHA) works with mortgage lenders to make loans available primarily to first-time home buyers, some FHA programs are open to investors. These loans can directly benefit you by providing government-secured financing for investment properties, especially if you're investing in residential real estate and multifamily housing. The FHA is the federal government's way of promoting the American Dream of homeownership.

TIP

As an investor, these programs can also benefit you indirectly — you can often use FHA loans to assist prospective buyers in financing the purchase of an investment property you're selling. One of the biggest obstacles preventing first-time buyers from purchasing a home is their inability to qualify for a conventional mortgage. FHA loans make qualifying much easier for them.

If you're working with a well-qualified mortgage broker (see Chapter 4) who has experience working with investors, she can direct you to FHA loan programs that you may be able to qualify for as an investor. The same is true if you're working directly with a lender who handles FHA loans.

To get more information about FHA loans and other programs straight from the source, visit the FHA Web site at `www.fha.gov`, where you can find information about the Good Neighbor Next Door program (described in Chapter 4), special loans for financing the development of multifamily housing and medical centers, streamlined FHA mortgages, 203(k) loans, and much more.

TIP

If you decide to sell a property you own, you can often attract more buyers if you advertise that you accept FHA financing. Also offer to put prospective buyers in touch with your mortgage broker, who can help them determine whether they qualify for an FHA loan. In addition to helping the buyers, your broker can screen out any *looky-loos* (casual browsers) who may not be able to afford the property.

If you're looking to invest in residential real estate, you may be able to turn to one of the following FHA loans. Check carefully (your lender or broker can assist you) because they have strict guidelines.

FHA 203(b) loans

FHA 203 loans are designed for first-time homebuyers and people who don't have a lot of money for a down payment. Investors can utilize these loans to help their potential buyers finance the purchase of their residential real estate, or to acquire and occupy a multifamily property. (You'd have to occupy at least one of the units in a multifamily property.) During the writing of this book, FHA 203b loans

- Are available only for owner-occupied, one- to four-family homes
- Allow borrowers to obtain a loan for up to 96.5 percent loan-to-value (LTV), meaning they can purchase a home with a down payment of as little as 3.5 percent of the property's market value
- Are *assumable* for a new purchaser, meaning the owner can get out from under the loan by arranging to have a buyer pick up the payments

TIP

FHA offers another program that you may find useful as an investor: *streamline refinancing*. This program enables you to lower your interest rate on a previous FHA loan with low or no out-of-pocket costs faster and with less documentation than most other refinance loans. For example, if you purchased a home with a $100,000 FHA loan as a home buyer a couple of years ago, moved out, and now use the home as an investment property, you may be able to refinance at a lower interest rate through this program. Even better, you can refinance all the way back up to the original loan amount (about $100,000 in this example) without obtaining a new appraisal, and roll all costs into the new loan — including any points you may pay to lower the rate.

Title I loans

Title I loans are available only for owner-occupied properties to enable homeowners to finance the cost of repairs and renovations up to $25,000.

Title I loans are great for investors who want to flip the property they're living in but don't have the cash on hand to bring the property up to market conditions. In a situation like this, you can use the Title I loan in either of the following ways:

- Take out the Title I loan yourself to pay for repairs and renovations before placing the property on the market.
- Place the home on the market as is (at a lower asking price) and let potential buyers know about the Title I loan they can take out to cover the cost of repairs and renovations after they take possession.

FHA 203(k) loans

FHA 203(k) loans are similar to Title I loans in that they're available only for owner-occupied properties and they allow the owner to finance the cost of repairs and renovations. The difference is that 203(k) loans allow the cost of *major* repairs to be combined with the purchase price of the property.

This program is ideal for investors who want to purchase a property, live in it while they're making repairs and renovations, and then sell it. Just make sure you don't overimprove the property and improve yourself right out of a profit. Also, your intent has to be to live in the house for at least 12 months as a primary residence.

For example, if a home is worth $100,000 now but would be worth $150,000 all fixed up, you can obtain an FHA 203(k) loan for the full $150,000 upfront, take your time completing the repairs and renovations, and then sell the property after you've lived in it for at least 12 months total.

Multifamily loans

For larger residential properties, FHA does offer a multifamily program that allows investors to purchase and rehabilitate apartment complex–type properties. You can often combine the FHA loan with other government grants or subsidies for improvements, tax credit, or rental payments such as the Section 8 program.

TIP

You can find out more about FHA programs for multifamily housing through HUD's Web site at `www.hud.gov/groups/multifamily.cfm`.

Viewing Veterans Affairs (VA) loans

As one of the perks for serving in the military, the U.S. Department of Veterans Affairs (VA) offers veterans zero-down financing to purchase owner-occupied one- to four-family properties. If you're a veteran, these loans are often the best deal in town. As an investor, you can often leverage the power of VA financing when you decide to sell a property — these loans give you access to another pool of potential buyers.

REMEMBER

Although VA loans are generally available only to veterans, even investors who aren't veterans can often obtain VA financing to purchase foreclosure properties that the VA owns.

Any mortgage broker or lender who handles VA loans can assist you in determining whether you qualify for one of the programs. Your broker may also be able to work with any prospective buyers (if you decide to sell the property) to determine whether they qualify for a VA loan, which may make the property more affordable to them. For more about VA loans, visit the VA's Web site at `www.va.gov` and then click "Benefits, Home Loans."

Considering REO loans

Real Estate Owned (REO) property is typically property repossessed by the bank after foreclosure. The bank now has to sell the property to recoup the remaining portion of the unpaid debt. With government-secured (FHA and VA) loans, the government agency that secured the loan gets stuck with the property.

Ideally, the government or bank that owns the REO wants someone to show up with cash and buy the property, but sometimes eager cash-heavy investors are few and far between. To add a little extra motivation, the owner of the REO property may offer to finance its purchase, sometimes offering very attractive deals and perhaps even the ever-elusive no-money down deal. These deals can be ideal for an investor because you can pick up the property at a great price *and* secure attractive financing in one fell swoop.

To obtain an REO loan, first find one or more properties that you want to purchase from a bank or government agency and then contact that agency and ask whether it's willing to finance the purchase. Experienced investors who have a proven track record of getting (and keeping) bad loans off the books have a better chance of obtaining this sort of financing. After all, the government or bank doesn't want to have to foreclose on the same property again.

For more in-depth information about REOs, check out our book *Foreclosure Investing For Dummies* (Wiley).

TIP

One of the best times to pursue REO's is when the housing market is in a slump and foreclosures are on the rise, as we discuss in Chapter 17.

Tapping into state and local grants and loans

State and local governments often identify certain target areas (such as rundown downtown districts, renaissance zones, and other areas in need of a pick-me-up) for redevelopment. They then offer incentives — usually in the form of state or local grants or low-interest loans — to get investors like you involved in pitching in.

REMEMBER

State and local grant and loan programs rarely get you *all* the money you need to purchase and rehab a property. They're intended as add-on programs, typically used in conjunction with other loans. Here we describe the most common types of state and local programs you're likely to find:

- **State housing development authorities:** Meant to encourage redevelopment in areas like Detroit or areas hit by disasters such as hurricanes, state housing development authorities often sell bonds to make money available to both homeowners and investors. They also fund special first-time home buyer programs and foreclosure rescue grant programs.
- **Renaissance zones:** Great for investors, *renaissance zones* are areas that federal, state, and/or local governments have declared tax-free (or tax-lite) to encourage development. In these zones, investors can secure loans with significantly lower monthly payments, sometimes saving hundreds or

thousands of dollars per month. It's like getting an interest-free loan, which dramatically increases your cash flow.

- **Economic development department:** To encourage development within certain areas, many larger cities have economic development departments that provide tax breaks, investment funding, capital expansion funds, construction, or rehabilitation grants to projects within their district.
- **Grants and specific use loans:** States, local governments, and some nonprofit agencies often provide loans or grants for improvement projects — such as health care facilities, women's shelters, and emergency housing — designed to add value to specific areas.

If your property is located in an area flagged for development or meets the state or local program's criteria, contact the state housing development authority, the city housing agency, and any nonprofit housing agencies to find out about available funds and what you need to do to qualify.

Start researching at the top — HUD's Web site at `www.hud.gov`. Here you can search for information by state, find out about economic development programs and grants, type in the address of a property to determine whether it's located in an enterprise zone, and discover other community networks and programs that can assist you in rebuilding communities while earning a profit for yourself.

To find state-level programs, head to your state's housing authority Web site. To find it, use your favorite Web search tool to search for your state's name followed by "housing authority." Your county, city, or town may also have its own housing authority, so use the same strategy to search for it. The Public Housing Directors Association (PHDA) also has a directory of members, which you can access by visiting `www.phada.org` and clicking the "Housing Authority Websites" link.

REO financing in action

The first foreclosure I (Chip) ever purchased was a vacant two-family dwelling, which I bought for $500 down and simply had to pay the balance of the previous loan. The seller, the Bank of Florida, financed the purchase over a five-year term. No qualifying, no closing costs!

We can't guarantee that a bank or government agency will be willing to finance the purchase for you, but it's certainly worth a try. You never know if you never ask.

Many mortgage brokers who are approved by their State Housing Development Authority can also provide valuable assistance.

Digging up USDA Rural Development loans

To encourage development of rural areas the USDA offers its own financing through Business and Industry (B&I) loans, discussed in Chapter 9, and rural development (RD) loans. As an investor, you don't qualify for the RD loans designed for residential home buyers, but these loans can benefit you indirectly if you buy and sell property in rural areas. Prospective buyers who can't obtain financing elsewhere may qualify for an RD loan.

For more about USDA loan programs to encourage rural development, visit `www.rurdev.usda.gov/rd/index.html`.

Avoiding the Prepayment Penalty Trap

When a bank loans you money for 30 years, it's counting on the fact that you're going to be paying interest to them for a long time. They have invested a certain amount of time and energy in originating that loan and need time to be able to make a profit off their investment (just like you do). The bank also doesn't want you refinancing with another bank a year or two down the road and cutting them out of the deal.

To discourage you from refinancing, and to help keep their initial costs low, the bank may try to slip a *prepayment penalty clause* into your mortgage. With this clause, if you refinance and try to pay off the loan early, you have to pay a stiff penalty — sometimes thousands of dollars.

When shopping for mortgages, be sure to ask whether the mortgage loan has any prepayment penalties and then read the mortgage carefully before signing it. Prepayment penalties typically apply for up to the first three years of the loan but can extend to longer periods on larger investment properties. If you have to refinance later, you don't want a prepayment penalty getting in the way.

Chapter 6

Bargain Hunting for Low-Cost Loans

In This Chapter

- Grasping interest rates concepts and calculations
- Understanding the term *term*
- Exploring closing costs and how they affect your wallet
- Figuring the bottom line — the total cost of a loan

Whether you're borrowing money to buy a place to live in or invest in, you're not just buying real estate — you're also buying money to finance the purchase. You're a consumer buying a product — in this case, a loan program — and you need to compare costs and benefits just as you do when you make any major purchasing decision.

Your goal is to find a loan that costs you the least amount of money over the life of the loan and requires monthly payments that you can afford and that ensure positive cash flows (as discussed in Chapter 5). The monthly payment part is fairly easy to figure out — lenders have to tell you what your monthly payments are going to be upfront. Determining how much it will cost you over the life of the loan, however, is a little trickier.

In this chapter, we show you how to shop for loans to find the one that costs the least and is best suited to your investment goals.

Understanding How This Interest Thing Works

Banks and other lenders primarily earn their money by charging *interest* on loans — a certain percentage of the *principal* owed on the loan (*principal* is the amount you owe on the loan). Well, that's certainly easy enough to understand, especially if you've purchased any big ticket item like a car or a house on credit.

In practice, however, interest can get pretty complicated. Lenders may choose to collect interest upfront in points, calculate your rate as simple interest, amortize the loan, or even play a game of "moving target" by adjusting the interest rate over the life of the loan. In the following sections, we sort out the complexities that surround interest rates and explain the essential jargon you're likely to encounter in plain English.

Keeping simple with simple interest

Simple interest is simple because you can usually calculate the amount of interest you need to pay in your head or with a very basic calculator. The formula goes like this:

Principal × Interest Rate = Annual Interest

You can then calculate your monthly interest by dividing by 12:

Annual Interest ÷ 12 Months Per Year = Monthly Interest

For example, say you borrow $100,000 at 8 percent interest:

$100,000 × .08 = $8,000 interest per year

$8,000 ÷ 12 = $666.67 interest per month

Because the formulas calculate only the interest owed on the loan, simple interest is perfect for interest-only loans. (Check out Chapter 5 for the ins and outs of interest-only loans.) Unless you're dealing with interest-only loans or smaller loans, such as home equity loans or lines of credit, you're unlikely to encounter simple interest. Most loans use more complicated methods to calculate interest.

Grasping the concept of amortization

If you ever looked at an amortization table or tried to set up your own spreadsheet to calculate amortization, you probably ended up bleary-eyed from trying to figure out how anyone could possibly have devised such a convoluted system for calculating house payments. *Amortization* is a method for calculating the retirement of debt that applies significantly higher portions of early payments toward interest and significantly higher portions of later payments to pay down the principal.

The mathematicians who devised this system had a method to their madness. They were attempting to create a system to provide for constant loan payments over a fixed period. The system also had to account for interest on the loan and the fact that each payment reduces the principal owed on the loan, which ultimately results in extinguishing the loan. In other words, they set some lofty goals.

Explaining how amortization works in theory is way too complicated, so consider the following example: Say you owe $100,000 at 8 percent interest over a 30-year term. The following steps show you how to calculate amortization and determine the amount of interest due for each payment:

1. **Determine the total monthly payment due.**

   This step is the most mathematically complicated. To figure your payment, plug the numbers into the following formula:

   $$A = \frac{i \times P \times (1+i)^n}{(1+i)^n - 1}$$

   A is the total monthly payment, *i* is the periodic interest rate, *P* is the principal, and *n* is the number of *periods* (payments over the life of the loan). The *periodic interest rate* is the annual interest rate divided by 12 months. The *number of periods* is the number of years times 12 months.

   Using this formula, your monthly payment on a $100,000 at 8 percent interest over a 30-year term comes to $733.76. Yep, this is why everyone uses a loan calculator or a spreadsheet instead of doing the math by hand, but we think you should know where the numbers are coming from.

2. **Calculate how much of the payment is interest by using the same formula you use to calculate simple interest.**

   Your payment consists of interest plus a reduction in the loan balance (principal). Here's that formula:

   Principal × Interest Rate ÷ 12 = Monthly Interest

   So, in this example, your interest on your first payment is $666.67: $100,000 × .08 ÷ 12 = $666.67

3. **Subtract your interest payment from your total payment to figure out how much principal you pay off.**

   Your first monthly payment of $733.76 breaks down like this:

   Total payment of $733.76 – $666.67 in interest = $67.09 of principal.

4. **For the next payment, subtract the amount you paid toward the principal from the total.**

   $100,000 – $67.09 = $99,932.91, so this figure is the number you use when you figure your next payment.

5. **Repeat Steps 1 through 4 for each subsequent payment.**

   Based on the calculation in Step 4, the interest portion of your second payment is $666.22:

   $99,932.91 × .08 ÷ 12 = $666.22

   With this payment, $67.54 goes toward principal, and with each subsequent payment you end up paying more toward the principal and less toward interest. This pattern continues until the entire balance is paid off in 360 months (30 years).

If you have Microsoft Excel, select File➪New and check the templates on your computer to determine whether your version of Excel comes with an amortization schedule. If it does, you can click it and click OK to create a new loan amortization schedule. Just plug in the loan amount, term, and interest rate, and Excel does the rest. If your version of Excel has no amortization template, you can download a free one and other real estate finance–related templates from Microsoft's Office Web site. Go to `office.microsoft.com`, click the Templates tab, click in the search box, type "amortization," and press Enter. You have several results to choose from.

Telling the difference between the interest rate and APR

Most people know that the interest rate and the annual percentage rate (APR) differ, but few people understand how they differ. The *interest rate* reflects the simple cost of the money you're borrowing. The *APR* is designed to reflect the total cost of the loan, including any loan origination fees and prepaid costs. As a result, the APR is higher than the simple interest rate.

Why use an APR? Congress designed the system back in 1974 as a way to enable consumers to more easily compare the actual costs associated with the loans. It sort of functions as a consumer protection tool, helping borrowers compare apples to apples in the world of personal finance.

For example, say you came into my (Chip's) office and I quoted you a 30-year mortgage loan for $200,000 at 6.50 percent. You talk to another loan officer who offers you the same deal at 6.25 percent. On the surface, you think this is a no-brainer — paying one-quarter percentage point less is going to save you money over the life of the loan. However, what if I'm charging zero points (*points* are prepaid interest; see "Paying interest upfront with points" later in this chapter), and this other guy is charging three points (in this case, $6,000)? Now it's not such a no-brainer.

Which deal is better? All other factors (loan origination fees and any other costs) being equal, mine is, and you can quickly see by looking at the APR:

- APR on 30-year fixed mortgage $200,000 at 6.50 percent with zero points: 6.5 percent.
- APR on a 30-year fixed mortgage $200,000 at 6.25 percent with three points: 6.626 percent.

What makes my deal even more attractive is that if you were to pay off the loan in less than 30 years (highly common, especially for investors), you'd save the $6,000 you would have paid in points to the other guy.

You can find several APR calculators on the Web by searching for, you guessed it, "APR calculator." One of our favorites is at `mortgages.interest.com/content/calculators/aprcalc.asp`.

Exploring how adjustable rate mortgages work

Adjustable rate mortgages (ARMs) are mortgage loans with interest rates that can fluctuate (rise or fall). During the mortgage meltdown, many unsuspecting homeowners got burned by ARMs they probably never should have been placed into. Although this has given ARMs a bad name, they're actually very useful, particularly for investors, as long as you use them strategically.

Not all ARMs are created equal, though. Several factors influence the best-case and worst-case scenarios of how low or high the interest rate can go, including the initial interest rate, the *adjustment period* (how often adjustments can be made), the *index* (the base interest rate you pay), the *margin* (the lender's markup on the index), and the *cap* (the highest rate the lender can charge). We explain these factors in greater detail in Chapter 5.

For example, say you take out an ARM to purchase a property that you're almost certain you can renovate and sell within a year. Taking out an ARM with a rate that stands to rise at the end of one or two years could be a reasonable gamble. And if you can get the ARM for a lower interest rate than the going rate for fixed-rate mortgages, the ARM can actually save you quite a bit of money.

Of course, taking out an ARM always carries some risk. Being "almost certain" you can sell the property within the year for more than you have in it is no guarantee. Whenever you invest in anything, you need to assess the risk/benefit ratio for yourself and determine just how much risk you're willing and able to take on.

Paying interest upfront with points

Plenty of lenders, particularly hard-money lenders, charge interest upfront in the form of points. (Hard-money lenders are private lenders; check out Chapter 11 for more on using these types of lenders.) So what are points? One *point* is equivalent to 1 percent of the total loan amount, so for every $100,000 you borrow, a point costs you $1,000. A point on a $200,000 loan costs $2,000.

So why do lenders use points? Lenders typically charge points for one of the following reasons:

- **To lower the interest rate:** When you choose to pay interest upfront, the lender may reduce your interest rate, so you pay less interest with each payment.
- **To get the money upfront:** If you pay back the loan quickly, the lender earns enough for taking the time to process your loan.

When you pay interest upfront to lower the interest rate, you may not see a net savings for several years. You can calculate the break-even point to determine whether you'll actually save money by paying upfront for a lower interest rate. The *break-even point* is the payment period at which you've saved enough money with the lower interest rate to pay the cost of the points:

1. **Start with the cost of the points.**

   Two points on a $100,000 loan cost $2,000.

2. **Determine your monthly savings per payment as a result of the lower interest rate.**

   To do this, simply subtract the monthly payment at the lower interest rate from the monthly payment at the higher rate. In this example, assume you're saving $50 per month.

3. **Divide the cost of the points by the monthly savings.**

   In this example, you divide $2,000 by $50, which equals 40. Your break-even point is at 40 months. If you plan on keeping the property for more than 40 months, you'll save money paying points. If not, it costs you more to pay points.

Of course, it gets more complicated when you take taxes into consideration, but this gives you a general idea of how points work.

Another reason you may want to pay points is so you can qualify for a larger loan, because the points you pay lower your monthly payment. Does paying points make sense? That depends. Crunch the numbers yourself. For example, a $100,000 loan at 7 percent interest over 30 years with zero points requires a monthly payment of $665.30. The same loan at 6 percent with 2 points would cost an extra $2,000 upfront but lower the payment to $599.55 — a monthly savings of $65.75. At that rate, breaking even on the upfront cost would take just under 31 months, but the investor would likely be able to claim a tax deduction for the costs, depending on his tax situation. In this case, paying points is an okay deal.

Although some people say they never pay points, and others recommend doing everything you can to lower the interest rate, points really have no *never* or *always.* Sometimes you have to pay points to gain access to the cash you need to do the deal, as we explain in Chapter 5.

Considering the Mortgage Term

When investing in residential real estate and looking for a low-cost loan, you need to take a close look at the mortgage term. A lender often quotes the mortgage *term* in years; for example, you may have a 15- or 30-year mortgage. However, for payment purposes you calculate the term on a monthly basis — 12 payment periods per year over 30 years equals a total of 360 months or payment periods. A 15-year mortgage has 180 payment periods.

Understanding the term is important because it ultimately affects how much money you end up paying for the loan over the life of the loan. For your average homeowner, a shorter term can pay dividends. Pay off a $200,000 loan in 15 years rather than 30, and you save a whopping $155,437.

However, as an investor, you have a different perspective. Investors like longer terms because they increase a property's cash flow, giving them more cash to do more deals. For example, payments on that 15-year mortgage would cost in excess of $467 more per month. That would significantly reduce monthly profit on any rental property and give you much less money to work with on other deals. ***Remember:*** As an investor, the longer the term, the better.

Accounting for Closing Costs

Every major newspaper has a financial section where banks, brokers, and other lending companies post their interest rates and often the points (prepaid interest) they're currently charging. Although this financial information gives you a general comparison of the going rates, it really doesn't help investors or home buyers comparison shop. These figures usually don't mention other costs associated with the loan, such as the loan origination fee, discount points, processing fees, paperwork fees, and junk fees. (For more about junk fees, see "Forking over other fees" later in this chapter.)

When comparison shopping for loans, you need to take these fees into account. In the following sections, we explain the most common closing costs you're likely to see.

Getting socked with origination fees

The *loan origination fee* is what the lender or broker charges you as a service fee for processing your loan. They're usually calculated the same way as points are — as a percentage of the total loan amount and charged as a cost to the borrower. For example, a 1 percent loan origination fee is 1 percent of the total loan amount, or $1,000 for every $100,000 you borrow.

TIP

Although most lenders charge a maximum of 1 percent, the loan origination fee is always negotiable. Sometimes, all you need to do is ask the loan officer to reduce the fee. In other cases, you may need to mention that Julie Swanson on the other side of town is charging less. For more tips on negotiating, check out *Negotiating For Dummies* by Michael C. Donaldson and David Frohnmayer (Wiley).

Although you may not consider the loan origination fee part of the loan, you should always include it in your calculations of the total cost of the loan. This strategy enables you to more effectively comparison-shop for the best deal.

Forking over other fees

Points and loan origination fees are only a couple of the legitimate expenses you can expect to see on a Good Faith Estimate (GFE) or HUD-1 (see the next section). Other legitimate fees include the following:

- Appraisal fee
- Closing or escrow fee

- Credit report fee
- Flood certification fee
- Lender fee (negotiable)
- Recording fees
- Reserves for paying taxes or insurance
- State tax/stamps
- Title insurance
- Underwriting fee (negotiable)

Some lenders include a *processing fee,* which is fairly standard but usually negotiable. (This fee covers the time and effort invested in handling the paperwork, along with any copy or printing costs.) You can usually figure out whether any of these fees is exorbitant by comparing a few Good Faith Estimates from other lenders.

Although we like to think of brokers and bankers as being trustworthy professionals, some are less forthright than others and are infamous for padding their closing fees with what the industry calls *junk fees.* One time I (Chip) was surprised to find an "e-mail fee" of $35 tacked onto my closing statement. Upon inquiry, I was told that this amount was what the title company charged to e-mail the documents over to the lender. How ridiculous! I was able to get it removed in about 45 seconds. Here are some other more common junk fees to watch out for:

- Administration fee
- Affiliate consulting fee
- Amortization fee
- Application fee
- Bank inspection fee
- Document preparation fee
- Document review fee
- Express mail fee
- Funding fee
- Lender's attorney fee
- Lender's inspection fee
- Messenger fee
- Notary fee
- Photograph fee
- Settlement fee
- Signup fee
- Translation fee

Junk fees can also be inflated costs of standard fees. If the going rate for overnight fees is $75, for example, and one lender tries to charge you $150, ask why.

Are Good Faith Estimates standardized?

When you start shopping for loans, you're likely to see all sorts of Good Faith Estimates, each of which categorizes its expenses differently and assigns each expense a different name. All these differences can make it difficult, if not impossible, to compare estimated closing costs.

Fortunately, the federal government is stepping up to deal with this issue. On November 12, 2008, HUD announced several new mortgage rules to help consumers shop for lower-cost home loans. One of the new rules requires that starting on January 1, 2010, lenders use a standardized GFE. The new three-page GFE benefits borrowers in two ways:

- When all lenders start using the form, the standardized model enables borrowers to compare costs line by line without having to decipher different names for the same charges.
- The new GFE contains line-item references to the same amounts on the HUD-1, making it easier to spot any changes between the estimated charges on the GFE and the actual charges on the HUD-1 at closing.

Examining the Good Faith Estimate

By law, your broker or lender is required to provide you with a detailed breakdown of all the costs associated with the loan (residential, not commercial loans). Lenders typically provide a Good Faith Estimate prior to processing your residential loan application and then a HUD-1 statement at closing detailing the actual final costs. (The *Good Faith Estimate* is a list of projected costs to the borrower, while the *HUD-1* breaks down all the actual costs that the seller and buyer are responsible for paying at closing.)

If the lender doesn't provide a Good Faith Estimate upfront, ask for one and make sure it's legible and understandable. Some lenders like to use fine print and shading to conceal what they're really charging and then give you a copy of the copy of the copy of the faxed original to make it completely unreadable.

Costs, particularly the loan origination fee and points, shouldn't change dramatically from what's on the Good Faith Estimate to what you see on the HUD-1 at closing. If you notice any change, bring it up at the closing table and don't sign the papers until any issues are resolved to your satisfaction and in writing. See Chapter 7 for more about covering your back at closing.

Calculating a Loan's Total Cost

Your bank or mortgage broker is likely to lay out a virtual buffet of loan types for you to choose from: fixed-interest, adjustable rate mortgage (ARM), interest-only, and others. We describe the pros and cons of these loan types in Chapter 5. If you're still unclear about the benefits and drawbacks of a particular loan program, ask the bank representative or your mortgage broker lots of questions.

TIP

Don't get too caught up in the various loan types. For people buying houses they plan to reside in for 30 years, loan type is a big factor. For real estate investors, particularly those who plan to sell the property or refinance the loan within a couple of years, the cost of the loan over the life of the loan becomes more important. To compare loans and find the best bargains, take the following steps:

1. **Start with the amount the bank charges you upfront in loan origination fees, points, and other fees.**

   REMEMBER

   When performing these calculations, include all points, but realize that not all points are created equal. Lenders can charge *discount points*, defined by some states as the legal cost associated with reducing the interest rate for a borrower. Lenders can also charge points as a fee (for example, *origination points*) that don't reduce the borrower's interest rate.

2. **Multiply the monthly payment times the number of months you plan to pay on the loan.**
3. **Add the two amounts to determine your total payment.**
4. **Total the amount of each payment that goes toward paying the principal of the loan.**

   Your lender can tell you how much of each payment goes toward principal.

5. **Subtract the total you determined in Step 4 from the total in Step 3.**

   The result is the total amount you can expect to pay for the loan over the life of the loan.

To save yourself some time performing these calculations, check out the mortgage payment calculator on our Mortgage Myths Web site at (`www.themortgagemyths.com`).

Say that you're considering two loans, each for $100,000. You plan on using the loan to buy and renovate a home over two years and then sell it and pay off the remaining principal on the loan. You have a choice between a 30-year, fixed-rate mortgage at 6 percent or a 30-year, interest-only loan at 5 percent. Look at the 6-percent, fixed-rate mortgage first:

Loan origination fee and discount points:	$1,000.00
Monthly payment of $599.55 × 24 months:	$14,389.20
Total payments (fees plus monthly payments):	$15,389.20
Total paid toward principal:	$2,531.75
Total cost of loan (payments minus principal paid):	$12,857.45

Here are the numbers for the 30-year, interest-only loan at 5 percent:

Loan origination fee and discount points:	$1,000.00
Monthly payment of $416.67 × 24 months:	$10,000.08
Total payments:	$11,000.08
Total paid toward principal:	$0.00
Total cost of loan:	$11,000.08

As you can see, even though you're not paying down the principal on the interest-only loan, over the life of the loan, you pay about $1,700 less. In addition, the interest-only loan has much lower monthly payments, freeing up cash to use for renovations and other investments.

TIP

As a general rule for *quick flips* (buying and selling a property in less than a year's time), opt for loans with low (or no) closing costs, low (or no) discount points, and low interest rates. Avoid any loans that have early-payment penalties.

Don't forget to account for cash flow and tax benefits that may be available. A lender may charge you $3,000 in points, but if you can write off a portion of that mortgage interest on your taxes, it may end up costing you less than $3,000. Also, always remember that having access to financing is often more important than the cost of that financing. Crunch the numbers to get the lowest-cost loan available, but don't beat yourself up if you have to pay more than average — as long as you can walk away with a decent profit and a positive cash flow.

WARNING!

One more, very important word of caution: Always factor in a margin of error to account for the unexpected.

Chapter 7

Navigating the Loan Application and Processing

In This Chapter

- Filling out a loan application
- Tracking your paperwork through the approval process
- Gathering 'round the closing table
- Getting a loan to finance investment-based residential property

Assuming you own the home you live in, you've already filled out at least one loan application and have been through one closing. Whether you did everything correctly is another question, but at least you have a general sense of how the process works.

As the buyer of a residential property and the borrower, you have the most papers to sign — papers dealing not only with the property you're buying but also with the loan you're taking out to finance the purchase. Faced with mountains of documents to sign, borrowers (even seasoned investors) often give the paperwork a cursory check at most before signing on the dotted line. This carelessness can be a big mistake, however, leaving you open to signing up for something you never really agreed to.

In this chapter, we review the closing process in greater detail and show you how to avoid many of the traps that ensnare even the savviest real estate investors.

Completing Your Loan Application

Filling out a loan application isn't exactly rocket science, but it does call for some careful attention to detail. The application requires specific and accurate financial details that enable your *loan originator* (broker or loan officer) and your lender to properly evaluate your current financial situation and your ability to make payments and repay the loan. In addition, the lender provides you with specific information, by way of lender disclosures, about the loan program and its costs.

In the following sections, we show you how to complete the loan application, review the various disclosures, supply the additional documentation your lender needs to process your application, and sign a release of information, so your lender can confirm the information you supply.

Walking through the parts of the loan application

In order to be able to accurately complete the loan application, you first need a good grasp on what the form comprises. Everything in your loan application package revolves around the *Uniform Residential Loan Application* — a five-page, fill-in-the-blank form that requests all sorts of information about the property you're buying and your financial situation. Although your loan originator actually prepares the form for you, go through the process yourself first so that you can gather the necessary information ahead of time and see for yourself what the lender looks at to determine whether you qualify for the loan.

REMEMBER

The Uniform Residential Loan Application is commonly referred to as the *FNMA (Fannie Mae) 1003 application* or simply the *Ten-Oh-Three*. To download the form, visit `www.efanniemae.com/sf/formsdocs/forms/1003.jsp` and click the link for the desired version — the blank form or an interactive version you can type your own entries into.

The form consists of ten sections:

- **I. Type of Mortgage and Terms of Loan:** Basic information about the loan, including the type (FHA, VA, Conventional, Rural), total loan amount, interest rate, *term* (number of months), and amortization type. Your loan originator can supply this information. Refer to Chapter 6 for details about amortization.
- **II. Property Information and Purpose of Loan:** Description of the property (including its location) and how you plan to use it: as a primary residence, secondary residence, or investment property. This section also covers whether the loan is for new construction or refinance, how the title will be held, and the source of the down payment and any closing costs.
- **III. Borrower Information:** General information about you, including your name, address, previous address, Social

Security Number, marital status, number of children (if any), and so on.

- **IV. Employment Information:** Information about your and any coborrower's employment, including names and addresses of the most recent three employers, dates of employment, and monthly gross income. The lender wants to know the past two to five years' history.
- **V. Monthly Income and Combined Housing Expense Information:** Information about monthly income including base pay, bonuses, overtime, commissions, dividends and interest, and rental income, along with housing expenses that include any monthly rent, existing home loan payment (principal and interest), property taxes, mortgage insurance, homeowners' association fees, and so forth.
- **VI. Assets and Liabilities:** The value of what you own *(assets)* and how much you owe *(liabilities).* Assets include balances in checking and savings accounts, stocks and bonds, the current cash value of any life insurance policies, vested interest in retirement funds, the value of any real estate you own, and so on. Liabilities include any current loans you have, credit card debt, alimony or child support payments, and job-related expenses (including child care).
- **VII. Details of Transaction:** Overview of the financial aspects of this particular loan, itemizing the costs and sources of financing. Costs include the purchase price, cost of alterations and improvements, cost of land (if purchased separately), *refinance costs* (debts to be paid off through the refinance), closing costs, cost of mortgage insurance, and so on. Sources of financing include the loan itself, closing costs paid for by the seller (if any), cash from the borrower, and other sources. You may need to consult your loan officer and others involved in the transaction to gather all the information you need.
- **VIII. Declarations:** Yes/no questions for you and your coborrower (if applicable) to determine whether past or present situations may affect your ability to make payments and pay the loan. Questions include whether you have any outstanding judgments, whether you've declared bankruptcy or suffered foreclosure, whether you're obligated to pay child support or alimony, and so on.
- **IX. Acknowledgement and Agreement:** Here is where you sign, acknowledging that the information in this loan application is correct to the best of your knowledge and that you and any coborrower are knowingly entering into this agreement with the lender.

- **X. Information for Government Monitoring Purposes:** Information that enables the government to track statistics on mortgages and homeownership relating to race and ethnicity. The information also enables the government to enforce any antidiscrimination rules and regulations.

TIP

As an investor, you know that the more prepared you are, the more quickly you get things done. The same is true with financing. By having all the necessary information at your fingertips, you can work with your lender (or loan officer) to complete your loan application in a matter of minutes.

WARNING!

Although you may be tempted to fudge the facts on the Uniform Residential Loan Application, don't do it (or allow anyone else to do it for you). Lying on a loan application is all too common, but it's also a felony. The rules are ultimately meant to protect you. If your net assets are too small to qualify for the loan, for example, then having your application rejected protects you from a potential financial nightmare. See lenders as your partners, not your enemies. For more about dodging the real estate and mortgage fraud bullet, turn to Chapter 2 for more info.

Reviewing the lender's disclosures

In the Declarations section of the 1003 (see the previous section), you and any coborrower must answer several disclosure questions as a way of "coming clean" about your current financial situation. Your lender also must commit to a certain level of transparency regarding its practices and the loan you're applying for. For example, by law, a lender can't play some cruel game of bait-and-switch on you by dangling an attractive set of numbers during the application process and then sticking you with a real stinker of a loan at closing.

TIP

Be sure to examine the lender's disclosures carefully before signing on the dotted line, as explained in the following sections. At the closing, make sure the lender adheres to whatever those disclosures stipulate. (For more about closing, skip ahead to the section entitled "Navigating the Closing.")

Program disclosures

Regardless of the loan program, be sure you fully understand the *program disclosures* (the terms of the loan agreement) before you sign anything. If you don't understand how a particular type of loan works, keep asking your mortgage expert questions until you fully understand what you're getting yourself into.

For example, some loan programs are straightforward. If you're taking out a 30-year mortgage at 7.5 percent interest, the lender has very little to disclose about the program itself. On the other hand, more-complicated loan programs may require that the lender provide an additional disclosure. With adjustable rate mortgage (ARM) programs, for example, the lender must notify you of the index it uses, the margin associated with the loan, and how and when the lender calculates changes to your interest rate. For more about ARMs, including the roles that the index and margin play, check out Chapter 5.

The disclosure may also contain a hypothetical example showing a brief history of changes and how your rate may have changed under that program if you had a loan with those terms. (For more about ARMs, including the roles that the index and margin play, head to Chapter 5.)

Good Faith Estimate

For all loan types, your lender is required by law to provide you with a ballpark figure of all the costs associated with this loan in the form of a *Good Faith Estimate* (or GFE, in industry lingo). The GFE provides a complete breakdown of all the costs associated with the loan you're applying for, including the loan origination fee, appraisal fee, and underwriting fee. Only by comparing GFEs can you get a good feel of what's normal and what's excessive in the market. Although the lender must supply the GFE to you within three days of receiving your application, most lenders offer the GFE prior to the application.

TIP

Ask for the GFE in advance, so you don't waste time applying for a loan you have no intention of following through on. In fact, obtain a GFE from at least three lenders so you can compare the programs and their costs. Watch for *junk fees* (unfair charges), as discussed in Chapter 6. If any of the costs on the GFE look out of the ordinary, ask about it.

Truth In Lending statement

The *Truth-In-Lending disclosure* (TIL) gives you a reflection of the true cost of the loan, including the interest rate and fees. In short, the TIL makes it easier for you to comparison-shop for loans.

One of the key items on the TIL is the *annual percentage rate (APR),* as discussed in Chapter 6. The APR shows you how much interest you're really paying on a loan if you include the upfront costs in your calculations. For example, say you're comparing the following two loans:

- $100,000 30-year fixed rate loan at 7 percent interest with finance costs of $5,000
- $100,000 30-year fixed rate loan at 8 percent interest with finance costs of $4,000

With numbers like these tossed about, comparison-shopping becomes almost impossible. At first glance, the second loan may seem like the better deal, costing $1,000 less upfront, but if you look at the APR, you get a different picture:

- The first loan has an APR of 7.52 percent and costs you $251,485 over the life of the loan.
- The second loan has an APR of 8.44 percent and costs you $274,723 over the life of the loan, or $23,238 more than loan one.

The TIL also discloses any late-payment fees associated with the loan, whether the loan has any early-payment penalties, and the proposed payment schedule. If the loan is an ARM loan, it may illustrate what will happen to the payments as the rate starts to change.

REMEMBER

The TIL is a great tool for taking a quick look at which loan among several is the best deal, but it doesn't provide enough information to evaluate specific costs associated with a particular loan. Use it in tandem with the GFE.

Real Estate Settlement Procedures Act (RESPA)

RESPA standardizes closings for residential real estate transactions in order to clamp down on any funny business that may occur at closing. According to the act, all closings must use a HUD-1 form to disclose the costs of the loan and show where all the disbursed funds are going.

TIP

Take a copy of your GFE to the closing to compare the fees disclosed on it with the fees actually being charged according to the HUD-1. This practice is one of the best ways to catch any discrepancies between what your loan originator told you and what it's actually charging you.

RESPA also controls certain actions of settlement providers such as the closing agent, and service providers (including the title insurance provider, credit company, and appraiser) to prevent them from working together against the best interests of the consumer (as in the case of price-gouging or kickbacks). Section 8 of RESPA has two important components:

- The first part prevents a lender from overcharging for settlement services and keeping the difference. For example, if the appraisal costs $400, the lender can't charge you $600 and pocket the extra $200.
- The second part prevents lenders and service providers from accepting or offering kickbacks for referral business — for example, a lender can't refer a specific appraiser and then accept part of the appraiser's fee as a reward.

RESPA's provisions cover all aspects of services, companies, and individuals, including title companies, attorneys, and real estate agents.

HOEPA — Section 32

The Home Ownership and Equity Protection Act (HOEPA) is an amendment to the *Truth In Lending Act* (TILA) to protect homeowners from paying excessive fees and interest. HOEPA is part of TILA but stands alone in its application; Congress passed these two separate acts:

- TILA covers all residential loan transactions (one- to four-family units), whether they're owner-occupied or investment properties. It doesn't apply to commercial loan transactions.
- HOEPA, also referred to as "Section 32" or "high-rate, high-fee loan disclosures," applies to residential owner-occupied dwellings for purchases and refinances. It includes one- to four-family owner-occupied properties (which could be a multiunit investment property in which one unit is occupied by the investor). It also applies to anyone you sell the property to. HOEPA doesn't apply to pure investment properties or commercial loan transactions, but you should always be aware of it so you know what's considered fair in terms of fees.

Under this regulation, lenders must warn borrowers if APRs exceed 10 percent of the comparable Treasury yield (which means Treasury securities having a similar period of maturity, such as 30 years), or if the deal's total points and fees exceed 8 percent of the loan amount.

REMEMBER

Most lenders don't offer loans that fall under Section 32, including to investors, so this regulation usually isn't an issue. Just be aware of these restrictions and limitations to make sure you're working with a lender who plays by the rules.

Supplying the requested documentation

In order to review your loan application, your lender needs some supporting documentation that verifies the information you supplied. Gather the following documents:

- Federal tax returns (with all attachments and schedules) for the past two years
- W-2s from the past two years
- 30-days' worth of paycheck stubs

- List of real estate owned, complete with income and expenses
- Any and all supporting documentation for assets and liabilities listed on the Uniform Residential Loan Application (bank statements, credit card statements, divorce decree, retirement earnings statements, and so on)

TIP

Make a copy of each document in the list and place them neatly in a folder labeled with your name and contact information. You can then hand the entire package (the copies, not the originals) over to your loan originator at your next meeting.

Signing a release of information

Providing your loan originator with a loan application package is like submitting a resume for a job — it paints a picture of you on paper, but it may not be an accurate portrait. To make sure the information is factual, your loan originator needs to verify it in the real world, usually by checking independent sources such as employers, banks, and even providers of government benefits.

Most lenders require that you sign a *borrow authorization form,* which gives them permission to check your credit and independently verify any information you provide for this transaction.

WARNING!

Before you sign the release, read it carefully to make sure it covers only this transaction. You don't want to give anyone carte blanche to poke around in your financial affairs whenever they want.

Additionally you may be asked to sign an IRS Form 4506 or 8821 for verifying tax return information. These forms are standard, but make sure you don't sign blank ones — make the lender fill out the years covered, or else it can go get your tax returns from six years ago.

Following the Loan Processing Trail

After you supply your prospective lender with a completed loan application and supporting documentation, all you can really do is wait. During this time, you may be wondering what the lender is doing, whether you need to be doing something, and how this whole loan application process is going to unfold.

To prevent anxiety from overtaking you, the following sections lead you through the course of a processing and keep you posted on the possible outcomes.

Getting up to speed on the underwriting process

You may be under the illusion that right now an accountant is combing through your loan application and supporting documents for proof that you're worthy of a loan. The fact is that nowadays computers actually do the initial screening. The information you provide is entered into an *automated underwriting* (AU) system, which performs a preliminary evaluation and spits out the conditions and documentation requirements of the loan.

The AU system can't deny your loan application. It can only place your application in one of the following three categories:

- **Accept/Eligible:** This category is the best; it means that you're approved for the loan, subject to certain conditions. Those conditions show up on the *findings* report and must be part of the file for final approval. The loan officer or processor obtains the necessary documents as requested and then submits the complete file to the underwriter to review for accuracy. The file is already approved at this point, so they're only looking to make sure you've submitted and signed each of the required supporting documents and disclosures.
- **Accept/Ineligible:** This category indicates that the loan is approved but is ineligible for purchase in the *conforming market* (Fannie Mae or Freddie Mac). For example, it may be a *jumbo* loan, where the loan amount is outside the upper limit of what Fannie and Freddie can purchase. Many investors still use AU systems and approve/buy these loans anyway.
- **Refer:** This category is also typically known as a *dead deal.* An underwriter still has to review the file before it can be denied, but loan files that fall in this category don't come with the same lender guarantees against loan losses, so the lender has no incentive to take on the additional risk of approval. Unless the loan can be repackaged and resubmitted to obtain a different AU result, the deal is likely DOA.

REMEMBER

Don't let a dead deal get you down. Even if you can't obtain a loan from traditional sources, you can usually find other means of financing your investments, as we explain in Part IV.

Obtaining an appraisal or AVM

One of the first things any lender wants to know is whether the property you're buying is worth the money you're borrowing to pay for it. Actually, it wants to make sure the property is worth more than the money you're borrowing so that if anything prevents you from paying back the loan, the lender has something of sufficient value to sell and recoup its investment.

To assess the value of a property, the lender orders an appraisal, an *Automated Valuation Model* (AVM) report, or both and usually charges you for it as a part of the cost of processing your loan. This appraisal isn't something you order — the lender wants to be in charge of picking an objective appraiser.

Expect to pay the full price for an appraisal, even if the property was recently appraised. Old appraisals can't be recertified no matter how recent they may be.

Appraisers generally take one of the following three approaches when performing an appraisal:

- **Sales comparison:** This most-common form of appraisal for residential properties compares the property to similar, recently sold properties in the same vicinity. The appraiser can then adjust her estimate by accounting for differences between the comparable homes and depreciation.
- **Income approach:** This method is used for income-producing properties, such as rental units. The appraiser compares similar properties in the same market to determine how much income the appraised property is likely to generate.
- **Cost approach:** This method is commonly used to establish the value of a unique property or properties in areas where few comparisons are available. The appraiser determines the value of the land and *improvements* (the building on the land) and then subtracts for depreciation.

An appraisal that uses the income approach is likely to cost a little more than a market-comparison appraisal, but not a whole lot more. If the lender tries to charge you hundreds of dollars more than you'd be paying for a standard appraisal (for a typical owner-occupied residential dwelling), find out why.

Having the property inspected

Whenever you make an offer on a property, make the offer contingent upon the property passing inspection, and then have the home professionally inspected. (This action is more for your protection than the lender's. Lenders usually don't require an inspection, even on government-secured loans.) This contingency ensures that you don't get stuck holding the bag on any of the following big-ticket items:

- Damaged foundation or other structural anomalies
- Electrical wiring problems
- Broken sewer lines, poor plumbing, or aging septic systems, especially if the house has been vacant for some time
- Leaking, nonfunctioning, or nonexistent gas lines
- Poorly functioning furnace or central air conditioning units
- Leaking or ramshackle roof
- Termite damage
- Health hazards such as lead-based paint, toxic mold, radon gas, asbestos, and hazardous insulation

In the following sections, we show you how to track down a professional home inspector and ensure that you obtain a thorough inspection.

Hiring a qualified home inspector

If you decide to hire an inspector, you can crack open the phone book and find listings for dozens of home inspectors in just about any area of the country. Finding a qualified home inspector, however, is a challenge. So where do you start? Ask the following individuals for referrals:

- **Your real estate agent or other real estate professionals you know:** By networking with homeowners, investors, and colleagues, real estate professionals know the best service providers in the area. Ask them for references to the best inspectors. If one inspector's name pops up on several lists, you've probably found a winner.
- **The National Association of Certified Home Inspectors (NACHI) Web site:** NACHI is a nonprofit agency that works toward educating and ensuring the quality of home inspectors. Its Web site at `www.nachi.org` features an online referral service that you can search to find certified home inspectors in your area. Make sure the inspector you hire is NACHI-certified — meaning the member has performed at least 250 inspections and passed two written proficiency exams.
- **Friends, family members, and colleagues:** Gather referrals from people you know and trust. Using an inspector who's done a satisfactory job for someone you know usually delivers better results than choosing someone blindly.

- **Your town's building inspection department:** Most towns have building inspectors who examine buildings as they're being constructed or renovated to ensure that they adhere to the local building codes. In some cases, you can hire the town's building inspectors to perform your inspection for you. They tend to be more thorough, and they're well versed on local building codes. The inspectors often show up as a team that typically includes a plumber, an electrician, a heating and air conditioning specialist, a builder, and someone who specializes in zoning. You get a thorough inspection and a complete write-up for about the same price as you'd pay a private inspector.
- **Better Business Bureau (BBB):** Although the BBB has a policy of not recommending certain businesses, it does offer a tool that enables you to search for BBB-certified businesses in your area. Start your search at `welcome.bbb.org`, where you can enter your ZIP code to skip to the Web site for the nearest BBB. You can then click the Find an Accredited BBB Business to start your search.

REMEMBER

When you have a few leads, contact your candidates and ask them the following questions:

- **Are you certified, licensed, and insured?** Certification and licensing ensure that the inspector has the basic qualifications for the job. Insurance covers any serious defects he may overlook.
- **How long have you been a home inspector?** Length of service is often, but not always, a good indication of experience and expertise. Someone who's been in the business for 10 years probably has more experience than a person who's just getting started.
- **How many homes have you inspected?** "One or two" isn't the answer you're looking for. A busy home inspector is usually busy because she's good.
- **What did you do before becoming a home inspector?** Someone who's a retired carpenter or home builder is probably a better candidate than, say, a burned-out English teacher.
- **Do you have references I can call?** If the inspector has a good track record, people don't hesitate to provide positive references.
- **Do you recommend remedies or simply identify problems?** Look for an inspector who's had experience in construction. Someone who not only points out problems but also recommends repairs and renovations is a good choice.

- **How much do you charge?** Most inspectors charge a flat fee of a few hundred bucks — more or less depending on the size of the home and the complexity of the inspection. As you interview candidates, you can get a pretty good idea of the going rate for a typical home inspection in your area.

After you gather answers and information from all your candidates, make a decision. Sit down with your list and identify the inspector who has the best experience and credentials of the bunch but doesn't charge an exorbitant fee.

Attending the inspection

Although attendance isn't mandatory, you should show up for the inspection prepared to take notes. Your notes should include the following:

- **Possible structural defects:** The inspector will point out cracked foundation walls, weak roof trusses, or shifting footings or joists. These problems can be extremely costly and can kill a deal quickly.
- **List of functional defects:** Examples include a furnace that no longer functions or is leaking carbon monoxide, or a toilet that doesn't flush. These are critical repairs that have the most impact on your ability to resell the property or lease it out.
- **List of potential environmental problems:** An example includes insulation that contains asbestos or ground on the lot that's been contaminated by a local industrial plant. These can be costly to fix.
- **List of cosmetic defects:** These include divots or dents in the walls, peeling paint, and other defects that just look bad. They're less-serious stuff.
- **Anything else the inspector points out:** These may range from minor issues, such as a leaky faucet, to more major issues, such as a stained ceiling that may be a sign of something more serious, but the inspector can't gain access to the area above the ceiling to check it out.

TIP

If you're note-taking challenged, consider carrying a digital recorder with you during the inspection. Just don't forget to turn it on.

Requesting repairs

With your list of property defects in hand, highlight the ones you expect the seller to repair and then have your agent present the list to the seller or seller's agent. The seller agrees to make all repairs, refuses to make all repairs, or agrees to make only some of the repairs. It's up to you to decide whether you want to move forward with the deal.

For any repairs you're willing to take on and other renovations to improve the property, obtain estimates from independent contractors to determine approximate costs. Get three bids from licensed professionals, including the time estimated to complete the work, as well as the lead time needed to schedule the work.

WARNING!

Don't get your inspector involved in providing estimates or doing any repairs or renovations to a property. This creates a conflict of interest, which is prohibited on government-insured loans.

For additional details on how to determine whether a property is likely to be a profitable investment, check out Ralph and Joe's *Flipping Houses For Dummies* (Wiley) and *Real Estate Investing For Dummies,* 2nd edition, by Eric Tyson and Robert S. Griswold (Wiley).

REMEMBER

When you're estimating the costs of repairs and renovations, keep in mind that as soon as you take possession of the property (at closing), you're responsible for the holding costs on the property when repairs are being done. (*Holding costs* are the expenses you incur when the property is just sitting there — they include the monthly mortgage payments, insurance, property taxes, and utilities.) By planning your repairs and renovations prior to closing and lining up contractors to begin work as soon as possible after closing, you can slash your holding costs.

Testing the water

You may not need to test the water as a condition for obtaining loan approval, but if the system is served by a well, get the water tested for your own protection. Your county health department or an independent lab can perform the required tests, but you need to collect the water:

1. **Get a clean bottle from the lab or your county health department.**
2. **Go to the water faucet farthest from the well source.**
3. **Let the water run for at least five minutes.**
4. **Fill the bottle and label it as instructed.**
5. **Have the sample tested right away.**

   The lab usually returns the results within a couple of days and lets you know the chemical makeup, including minerals and any detectable E. coli in the water.

If the property is serviced by a community well, request maintenance records.

I, Chip, usually steer clear of properties serviced by community wells. I also avoid properties on which the well is located in a crawl space or basement. These pose financing risks, and any eventual buyer will be limited in financing options.

Having the septic system inspected

If the property relies on a septic system, have a qualified septic contractor inspect the field, saturation levels, and estimated remaining life of the system. These systems can be very costly to replace.

Also, research the pumping records with the owner and the county (usually the county health department), and check with the county on the age of the system and its maintenance history. The county should have records of when the system was installed and a pump card that shows when it was last pumped out.

If the system is more than 10 years old, we highly recommend that you have a qualified professional perform a *perk test*. This test makes sure the septic field is draining properly and isn't saturated (a situation that indicates a short remaining life).

Obtaining a survey

Your lender will request a survey on the property, regardless of the size of the parcel, even if it's a *platted lot* (a lot with boundaries shown on a map). To insure the transaction, the title company requires a survey or certification of an existing survey. Surveys come in two types:

- **Boundary survey:** This type illustrates where the property lines are and is usually sufficient for a platted lot, because the parcel's boundaries have already been recorded.
- **Stake survey:** With this type the surveyor actually goes out and places or finds metal boundary stakes to certify the actual boundary lines of the parcel. The stake survey is slightly more expensive, but it's the better choice for waterfront property, irregular parcels, and properties with a *metes-and-bounds description* (commonly found in a deed).

Walk the property with the owner to be sure you know where the boundary lines are, and ask questions about any easements or encroachments that may exist. If the owner/seller has a copy of the previous survey, obtain a copy so the surveyor can recertify it instead of performing a new survey — you may save a few bucks.

Navigating the Closing

Although the closing (or settlement) is the final step in the real estate transaction, it can feel a little anticlimactic. You and the other participants in the transaction have completed your work. Now you're simply meeting to sign off on the deal you've all agreed to and shuffle the money around to the appropriate recipients.

Even though the process may seem like an afterthought on a long journey, you really need to stay on your toes to avoid any last-minute mishaps. In the following sections, we show you how to ensure that the closing proceeds smoothly without any glitches that can negatively affect your bottom line.

Keeping your attorney in the loop

A good real estate attorney can keep you from spending thousands of dollars later to clean up a mess that you can easily avoid now. Get your attorney involved sooner rather than later in the following ways:

- **Make sure your attorney reviews the purchase agreement before you make an offer.** Consider working with your attorney to develop a boilerplate purchase agreement you can use for all of your transactions, so your attorney doesn't have to review it every time.
- **Have your attorney present during any sensitive or unusual negotiations.** If you're not completely comfortable with something the seller or seller's representative is saying, consult your attorney before giving a final response. Backing away from something you agreed to, even verbally, can make your attorney's job more difficult later.
- **Ask your attorney to review the closing papers prior to the closing date.** Have the company handling the closing supply you with copies at least three days in advance.

Get your attorney involved early. She probably won't be able to help you after the closing; even if she can, it'll cost you a whole lot more than if you had corrected the errors *before* you signed the papers.

Dealing with the preliminaries

Closings usually proceed smoothly as long as you have all the parts in place prior to closing. In the following sections, we show you how to prepare for your next closing.

Hiring a title company

Closing is pretty easy, at least from your perspective. In most cases, your agent or the seller's agent selects a title company, and the title company does the rest — gathering all the essential paperwork, making sure everyone shows up to the closing on time, and then routing the closing documents around the table to make sure everything gets signed.

The title company also provides title insurance — your only protection from future claims against the property, including old co-owners, *lien holders* (other parties that claim rights to the property), *backside deals* (private negotiated or unrecorded agreements) with neighbors, and a whole host of other potential problems. Approximately a month after closing, the title company sends you a complete policy. Store it in a safe place — in addition to providing you with a record that you have title insurance, the policy can earn you credit toward the next policy when you sell or refinance the property.

Never ever purchase a property without title insurance. Without title insurance, you can lose your entire investment overnight. One way this can and has happened is when a scam artist sells a property he doesn't own. The con artist waits until the owners are on an extended vacation and uses a phony deed to transfer the property into his own name. He then lists and sells the property and takes off with the cash. If you happen to have bought the place, and you don't have title insurance, when the rightful owners return from vacation, you lose the property, but you still owe on that loan you took out to buy it.

Under RESPA (Section 9), you as purchaser have the exclusive right to select the title insurance provider. We encourage you to go with one of the national agencies or one of their agents — someone with a solid reputation in the marketplace. In addition, larger companies have several offices, making dealings more convenient when closing time arrives.

Request an *insured closing letter*, indicating that the title company is insured for handling the transaction. This document provides you with the assurance that if the closing company mishandles anything, you don't get stuck with a bill for its mistake.

The title company disburses funds on investment properties immediately upon the close of the transaction. Request a copy of each disbursement check for your records.

Reviewing the documents in advance

You have the right to review any closing documents at least 24 hours prior to closing (preferably three days before closing, so your attorney has time to review them, too). As soon as you've chosen a title company, contact the company and let your representative know that you want a copy of the closing packet as soon as possible so you have time to review the paperwork.

Check the mortgage, deed, note, HUD-1 closing statement, and all other documents for spelling or calculation errors, and make sure the figures on the HUD-1 match up with those on the Good Faith Estimate. If anything looks odd, call the title company and have your issues addressed *before* closing.

Insuring the property

Several days prior to closing, meet with your insurance provider and review coverage options for the property you're about to purchase. Let your agent know the closing date so he can prepare a policy for you in advance of the closing.

Make sure you obtain a *policy* and not just an *insurance binder* (a promise to insure) — some lenders don't accept binders.

Signing the documents

Be prepared to sign a lot of documents during closing (and no, you can't use a rubber stamp!) You have to provide a picture ID (such as a driver's license). The closing agent witnesses and notarizes your signature many times during the closing.

Request a complete copy set of all *signed* documents (not just blank ones) and keep them in a safe place just in case you need them in the future. In the court of real estate law, only signed documents count, so be sure you get a copy of the signed documents showing what you and the seller agreed to.

Knowing your right of rescission . . . or lack thereof

The *right of rescission* is a federal law that gives you three days to change your mind on financial deals. It protects consumers from high-pressure sales tactics. Commonly called the "cooling-off law," it also allows you to back out of refinance deals on owner-occupied residences.

As an investor, don't count on the right of rescission to protect you. It doesn't apply to the purchase agreement — after you sign the agreement, your offer is binding. In addition, the right applies only to owner-occupied residences, not investment properties.

Dealing with surprises

The key to dealing effectively with surprises at closing is to not have any surprises. In the following sections, you discover some prevention maneuvers that ensure a smooth closing.

Rate changes

Your interest-rate lock agreement is only as good as the loan officer who gave it to you. You have nothing in writing to say that the person actually locked in the rate with an investor or that the terms of your application didn't change just enough to allow (or require) the loan officer to place it with a different lender-investor or a completely different loan program.

At least two days prior to closing, confirm your interest rate and program with the loan officer. If you had been floating the interest rate, he will require you to lock it in at least three days prior to close so that he can prepare the documents. If it's not what you agreed upon, hold out until you're satisfied with the rate and terms. You won't be able to change them after the closing.

Term changes

Confirm the terms of your loan (including index, margin, and start rate for an ARM loan) prior to the closing. Your loan terms should remain fixed unless something major occurred between the time of your application and the closing, but ask anyway. You don't want any surprises.

Dodging disaster

How would you like to purchase a property and have it burn down the next day without having insurance to cover it? I, Chip, almost had that happen to me. However, the property actually burned down a day *before* closing. Fortunately, the previous owners hadn't cancelled their policy prior to close, or it would have been a real mess. We had to wait for the property to be rebuilt before we could close on the transaction — a delay of five months!

The moral of this story: Obtain an insurance policy before closing. Don't leave the property uninsured for even one minute — too many things can happen.

If rates improved since you obtained loan approval, or the property numbers no longer meet your expectations, you may consider changing loan programs in order to maximize your cash flow. Just remember that any changes you make now cancel out the rate and terms you locked in. Even a slight change can jeopardize your lock, giving the lender an opportunity to charge extra fees and interest, so be careful.

Other unexpected events

Once in awhile, other events throw a wrench into the proceedings — and they're completely beyond your control. The seller may have a change of heart, the title company may require additional documentation to insure the title transfer, you may have to get lien waivers, and so on. Take it all in stride — and prepare for a delay. We've had lots of closings slightly postponed while someone fixed a glitch, so keep your schedule (and that of your contractors) a little loose.

You're dealing with professionals, and they're programmed to get any problems resolved as quickly as possible. If anything sounds too strange or flat-out made up, simply ask your attorney to call the title company or closing agent. That usually gets the process back on track pretty quickly!

Financing Other Types of Residential Properties

Most of the information in this chapter relates to financing the purchase of primary residences. Variations arise, however, when you're financing the purchase of other types of properties, including vacation and investment properties and vacant land. The following sections introduce the variables you can expect and show you how to deal with them.

Digging up money for vacation properties

If you're in the market for a vacation property or second home, expect the financing requirements to be a lot tighter, the interest rate and costs to be higher, and the down-payment requirements to be greater, with many lenders requiring at least 20 to 25 percent down.

Due to the higher costs, you may want to consider purchasing a *fractional ownership,* in which you share the property with several parties. This can be a great way to invest in higher-end properties located in expensive markets. You can usually find a loan officer who specializes in these types of loans.

Banks and other more traditional lenders rarely handle loans for fractional ownerships, so you have to go through a specialized group of finance companies. Shop around carefully for one that specializes in this type of financing, and make sure that you have a solid agreement with the other parties involved. Make absolutely sure that your real estate attorney reviews all the paperwork and that you fully understand what you're getting yourself into.

WARNING!

A management company often makes all the arrangements, but make sure you understand your obligations as an owner and how the parties plan to share the income and expenses of the rentals or the burden of expenses when the rentals are vacant? For more information, check out *Second Homes For Dummies* by Bridget McCrea and Stephen Spignesi (Wiley).

Financing investment properties

Lenders approach the financing of *residential investment properties* (dwellings you rent out) more carefully than they do financing the purchase of primary residences. As a result, you need to adjust your expectations and approach to financing these properties in a different way as well. We cover the main differences that come with these properties in the following sections.

Options for financing residential investment properties are somewhat limited. Expect interest rates, costs, and the down-payment requirements to all be higher. Often, lenders require a minimum of 25 percent down.

Shop around for a lender that offers several options for investment properties, and be careful of extra fees. You should have to pay only an additional 1.5 to 2 points above a normal owner-occupied transaction. Check out Chapter 4 to find out how to shop around for lenders.

Before approving a loan for any income-producing property, your lender wants to know whether it promises a positive cash flow. Of course, you want to know this, too, so before you even submit an offer, perform a complete cash flow analysis of the property, as explained in Chapter 3. Do the math before you do the deal, and if the return on your investment is less than you'd earn by investing