Teleseminar 2

<u>Your Social Life - Financing of Real Estate 101</u>

"If you hang out with chickens, you're going to cluck
and if you hang out with eagles, you're going to fly."
Steve Maraboli

<u>Introduction</u>

Power of thought cannot be underestimated! Thought is the unquantifiable force which causes action. When you believe something strongly and without equivocation, it has the effect of causing you to act as though it has already materialized. The phrase *fake it 'till you make it* comes to mind.

In the early 1990s, when Jim Carrey was still a struggling young comedian, he wrote himself a ten million dollar check for acting services rendered. He dated the check Thanksgiving 1995. He carried this check in his wallet from that day forward. Mr. Carrey saw that payday in his mind so clearly that as far as he was concerned the money was already his, he was just waiting to cash the check! Then, right before Thanksgiving 1995, he found out that he was going to be paid ten million dollars for *Dumb & Dumber.*

Here's the thing – Whether you are cognizant of it or not, your thoughts are greatly influenced by your environment; more specifically the people with whom you associate. Attitudes are contagious. Are there people in your inner circle who promote positive thought? Are there people around you whose ability to internalize success is so powerful that it is contagious? According to Jim Carrey himself, his father was the beacon of conviction in Jim's life.

Who Do YOU Call ???

Mortgage Banker
Attorney
CPA
RE Agent
RE Broker
Appraiser

Mortgage Broker
Investor
Investor
Investor
Investor
Investor

Commercial Banker

If you scroll through the call history in your phone, how many millionaires (non-related to you) did you speak with this week? How about bankers, CPAs, attorneys, investors, mortgage brokers, business brokers are on the call list? Probably none. This means the time has come to change your environment.

But how? How do you leave the place where you are, (the couch in your living room in front of the TV) and find yourself surrounded by the doers among us?

Relationships are built on common ground. You start by learning to speak their language. Think of it this way; you don't show up to a baseball game with a hockey stick. You've got to have the right equipment or they won't let you in the game!

In this chapter, you will begin to learn how to speak to an institutional real estate financier such as a banker or a mortgage broker. First thing to note is that there are two types of institutional lending. On one hand, there are lenders who specialize in the typical 15- to 30-year single family or a small multi-plex residential mortgages which will be sold on the secondary market. On the other hand, there are portfolio lenders (mostly commercial loans) which retain the loans on their books. In the beginning, most of you will be working with the mortgage bankers and brokers in the first category, thus the focus of this chapter is limited to the arena of residential, 1-4 unit mortgages.

What is the Secondary Market?

Even before the ink is dry on your mortgage paper, the lender who gave you the loan will be looking to sell it. The questions are: why sell the loan, and to whom?

The reason they sell is because this frees-up capital to make more loans, and also limits the bank's losses in case you default on your loan. A pretty sweet deal for the banks – they love it. The answer to the question of who buys these mortgages is: private institutional investors and government agencies that comprise the secondary mortgage market.

Here is the gist of how this process works. Let's say your bank gives you a mortgage. Within a short time this mortgage is sold to one of the agencies in the secondary market, who can hold it in its portfolio and collect interest income. However, more often the secondary market agency resells your mortgage to investors throughout the world in the form of Mortgage Backed Security (MBS).

Here is how MBS works in a nutshell. Suppose an institution in the secondary market buys 1,000 mortgages from primary lenders from all over the country. It would then take each one of these and "slice" it into 100 small pieces. Then, this institution would take 10, 20, 30, etc., of these small portions from mortgages that came from different parts of the country and group them together into an MBS.

The fact is that each MBS is backed by original mortgages from different parts of the country. On top of that, it is not the entire mortgages but only small portions of the original that are inside each MBS. This was supposed to make them well-diversified and safe interest income investments. But alas, we all know how that turned out. When mortgages started going bad in mass around 2007, it was next to impossible to tell which ones and who they were sold to because these securities were so sliced-up.

Having said this, the secondary market is absolutely integral component to our financial system. The secondary market was created with the formation of Fannie Mae in 1938 as part of President Roosevelt's New Deal. The intention was to stabilize the real estate cycles, but whether or not this worked is debatable. However, secondary market has had the effect of making homeownership in America much more affordable. Prior to 1938, when the government created Fannie Mae, it was common for banks to demand 50% down-payment and only allow for 5-year repayment schedule (amortization). The banks did this in order to curtail risk. They wanted to make sure that the borrower was extremely well qualified and that the banks money wasn't getting tied-up for too long since this loan was going to remain on the books of the lender. This meant that very few people could afford to own a home.

When government entered the mortgage business via the secondary market and Fannie Mae, (later Ginnie Mae and Freddie Mac), the risk was essentially taken off the table for the banks. The lenders could now sell the mortgages, which meant that if the mortgage went into default at any point after the sale, the investor who bought it was on the hook for the losses and not the bank that originated the mortgage.

This led to a loosening of the underwriting standards. The politicians were happy because they were creating an opportunity for more people to own a home. The banks were happy because they could make money quickly since they could now sell the mortgages and get the majority of their money back immediately with very little risk in the process. Over the following 60 – 70 years this mentality led to led to the extremely loose qualifying standards for borrowers, which resulted in the real estate bubble, which burst in 2007. We are still dealing with the effects of this bubble in 2012.

Effects of the Secondary Markets on Real Estate Market

1. Lower Interest Rate
2. Longer Amortization
3. Lesser down-payment requirement
4. Standardized Qualifying Process and Criterion

Increased Affordability

Increased Rates of Ownership

This gives you a bird's eye view of the secondary mortgage market. I give you this information because it's good to be an educated consumer, and because the guidelines relative to your ability to finance single family, 2, 3, or 4-unit residential investment property are defined by the two largest investors in the secondary market Fannie Mae and Freddie Mac. At least in the beginning, the cheapest financing with the lowest monthly payments available to you will be mortgages that will be sold on the secondary market. As such, it is good for you to know how things work. Next, we consider some of the elements that your lender will consider as part of you application for mortgage financing.

<u>What will a banker look for when you apply for a loan?</u>

This general heading is subdivided into two subheadings: elements relative to you, and elements relative to the specific transaction. Relative to you, there are three main elements which will be considered by the lender:

1. ***Credit Score***
2. ***Debt to Income Ratio (monthly)***
3. ***Net Worth***

<u>Credit Score</u>

Credit score is one of those mysterious things in life that everyone knows about but nobody knows exactly what it is, where it comes from, or what it's for. I contend that you can't live without it but you should try not to live with it. Intrigued? Let me decipher the mystery.

As far as most people are concerned, good credit score allows them to buy "stuff" by borrowing money from the bank. For most people this means that the better their credit, the more consumer debt they have – things such as cars, boats, motorcycles, etc. But here is a thought. While I also need to rely on credit to build my portfolio assets, my goal is to have so much money that I can tell the banks to take a hike. When you have the money, you don't need credit. Do you realize that it is actually possible for a very successful and wealthy person to have no credit score? If you have no debt, the credit reporting agencies simply can not calculate a score! It is a debt score; no debt – no score.

I simple terms, credit score is a number assigned to you by the three credit reporting agencies which quantifies your ability to borrow money. Lenders look to this number to establish whether they should extend financing to you. The higher the number, the more likely you are to be able to get a loan.

The three credit reporting agencies are *Equifax, Experian,* and *TransUnion* – Google them. They each calculate your score a bit differently, but it is always based on your track record of paying back debt and your income-to-debt ratio, which I'll be discussing in the next section. Each type of deficiency is assigned a value – the more egregious the deficiency, the more it costs you in a way of the credit score. In addition, the number of these negative entrees also impacts the score. For instance, having an unpaid cell phone bill may drag your score down 30 or 50 points, but having an unpaid medical bill and a gas bill on top of that could drag your score down 120 points or more. Furthermore, the longer you let it go, the more the negative impact. Finally, something like a foreclosure or a bankruptcy will render you un-financeable for 3-7 years!

I do not have much experience with credit repair, so I am not able to tell you a definitive way to rebuild your credit score. I am sure you've heard commercials on TV professing to rebuild credit in 2 months. I don't know if this is even possible. However, there are steps you can take to help your case.

First of all, review your credit report to determine if all of the information in it is correct. If you find any discrepancies, write a letter to the reporting agency asking them to either correct the mistake or remove it from your credit report. Make sure that you utilize certified mail for any such communications so that you can prove having sent the letter. When you do this, you need to know that by law, the credit agency must get back in touch with you within a specified time with their findings (I am not sure what this time-frame is, so do some research).

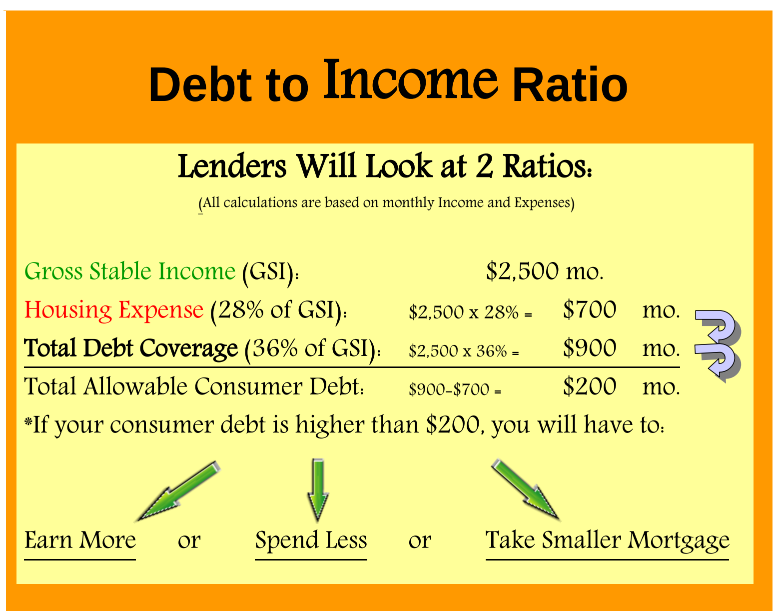
Once in a while, the mistake you find will be an obvious error on the part of credit reporting agency, in which case they should correct it immediately. But most of the time, once the credit agency receives your request, they will likely contact the creditor whose entree you are disputing giving them a certain time to validate their claim. If the creditor does not respond promptly, the credit reporting agency should remove this entree from your credit report. This is where you can get lucky, because often the creditors misplace your paperwork, or they are too busy frying bigger fish, or there is some other glitch in their systems that prevents them from reporting back quickly. So this is worth a shot.

Finally, if all else fails, you can call up the creditor and try to settle for less than what you owe, or work out some kind of payment plan. Settling will impact your credit score but not as much as having this unpaid balance linger. If you sign onto a payment plan, you can request that the creditor report your progress monthly, which will have positive impact on your score.

In conclusion, your credit score tells potential lenders about your habits around debt. The moral of this story is – if you must borrow money, repay on time. Over the long term, you will find it much easier to do business if people can trust that you are good for the money! If you plan to finance property by utilizing conventional lenders, you should be able to get a reasonably good loan with a credit score of 620 or better. If yours is lower - get to work!

Debt to Income Ratio

Debt to income ratio is the relationship of your income to you monthly recurring expenses represented as a percentage. Let me walk you through what the banker is going to be evaluating relative to your income and expenses.



Let's say your gross monthly income is $2,500, while your monthly expenses are $2,000. To find out the debt to income ratio simply divide $2,000 by $2,500 to get 80%. This means that you spend 80% of your income to cover your monthly expenses.

Relative to your income, the first thing the banker wants to know is whether this can be qualified as *stable* income. The bank is considering giving you money, so it's natural that they want to make sure that you didn't just come into a job two months ago.

If you can prove that you've been making this money for a while, the bank is likely to assume that you will continue being able to earn this income in the future, and therefore be able to pay them. What this means to you in practical terms is that you have to be able to produce proof of income. If you are a W2 employee, then you may need to show the bank 6 to 12 months of paystubs. If you are self-employed, the bank will likely want to see 2 to 3 years of tax returns.

Once your income has been established, the banker will consider two ratios as part of evaluating your income to debt ratio. The first is your *Housing Expense Ratio*, which according to the secondary market underwriting guidelines as of 2011 can not exceed 28% on a conventional loan. This housing expense ratio determines the maximum amount of money that you can spend on housing every month. Thus, if your monthly gross income is $2,500, you would multiply that by 0.28 to find that your maximum allowed home payment is $700 per month. Incidentally, this maximum payment has to include **PITI** (remember this term as you will see it a lot), which stands for Principal, Interest, Taxes, and Insurance.

But there is a catch. The second ratio that your bank will consider is your *Total Debt Ratio*, which is the ratio of <u>ALL</u> of your monthly expenses (including your housing expense) to your gross income. As of 2011, this ratio can not exceed 36% for conventional loans. If you multiply your gross income of $2,500 BY 0.36, you will find out that the maximum you can spend on EVERYTHING is no more than $900. This means that if your recurring expenses such as car payments, credit cards, installment loans, etc. are $200 or less, then you will be able to maximize your mortgage borrowing and take on a payment of full $700 per month. But let's say that you have a car payment of $150 per month, two credit card payments of $50 each, and a payment for the computer you bout two years ago of $60 per month, totaling $310 per month. Since the most you are allowed to spend on everything on a monthly basis according to the secondary market is $900, we can subtract $310 from $900 to find out that you will qualify for a monthly house payment of at most $590, not $700. Just so you know, that's a difference of being able to qualify for a mortgage of about $117,000 verses $98,000 at 6% and 30-year amortization. My question: Were the credit cards worth it?

<u>Net Worth</u>

The last metric relative to you that the banker will want to know is your net worth. Just a reminder; net worth is assets minus liabilities. In their book entitled *The Millionaire Next Door,* authors Thomas J. Stanley, William D. Danko came up with a clever formula to approximate what your net worth should be, and it seems to make sense to me. According to them, if you multiply you annual gross income by your age and then divide by 10, you will find out what you net worth should be relative to your income and age. So, continuing with the previous example, and assuming that you are 35 years old, your net worth should be $30,000 x 35 / 10 = $105,000. If it is, then you are doing O.K. If it is not, then some things need to change…

Having said this, in my experience the banks put much more weight on your credit score and income to debt ratio than net worth. The first two communicate a lot more about your money management habits, and this is their main concern. They will not disqualify your loan if you're worth $60,000 as opposed to $120,000, though they may dig a little deeper to find out why. But at the end of the day, all they really want to know is that you are not in the red; that your assets are greater than your liabilities. Regardless, in my opinion your ability to accumulate wealth should concern you very much!

And this concludes the discussion of the elements that your banker will consider relative to you. Specific to the transaction, you and your banker will want to establish the following:

1. ***Down Payment***
2. ***Loan to Value Ratio (LTV) and Appraised Value***
3. ***Closing Costs***
4. ***Amortization***
5. ***ARM (Adjustable Rate Mortgage)***
6. ***Balloon Mortgage***

Down Payment

The amount of down payment you are able to make is one of the first questions to be answered for several reasons. First, obviously the more money you put down the less you have to finance. Traditional lenders like that. Also, the more you can put down, the more "stable" you will seem to them.

Just so you know, to the best of my knowledge the current regulations put forth by the secondary market stipulate a 25% down payment when financing an investment property, which is quite a lot! Not many people have $25,000 to put down on a $100,000 property. This wasn't always the case. There was a time when lenders were willing to finance investment property with substantially smaller down-payments. But, in light of the current financial crisis which was brought on in large part by loose lending, the secondary market tightened the regulations. For this reason, in today's market I do not consider conventional financing desirable for purchase of investment property. The cost of entry is just too high. However, if you already own a property with 25% equity, there is a possibility of an advantageous refinance.

Loan to Value Ratio (LTV) and Appraised Value

LTV is the measure of the amount financed juxtaposed against the value of the property. For example, if you are buying a property that's valued at $100,000, but you are only asking for $75,000 of financing, then the LTV is 75%. ($75,000 / %100,000 = 75%) By extension, if a bank is offering you financing at 75% LTV, it means that you will need to make a 25% down-payment. In the world of conventional lending, down-payment plus LTV equals the value of the property. Thus far LTV is a rather intuitive concept. Where it gets somewhat intricate is in the definition of value.

LTV – Loan to Value Ratio

LTV – The Amount of the Loan Relative to Price of the Property and Represented as a %

Value of the Property:		**$100,000**
Loan at 75% LTV:	$100,000 x 75% -	**$75,000**
Down-Payment (25%):		**$25,000**

For example, you should know by now that relative to purchase of real property the value should be established through *the meeting of the minds*; it is what a buyer is willing to pay and what the seller is willing to accept. Therefore, you would think that the contracted purchase price should represent the definitive value. However, as part of the process of qualifying you for a loan, the banker will order an *appraisal* of the property. They do this because they are aware that the real estate is an inefficient market, and as a result you may have agreed to pay too much.

For example, let's say that you've contracted to buy a *duplex* (2-unit) for $100,000 at 75% LTV. This would mean that you are prepared to put $25,000 down. But if the bank determines based on the appraisal that this building is only worth $95,000, and notifies you that they will only lend money to you based on the value of $95,000, the most financing you will get is $71,250.

At this point you have two options. One option is to back to the drawing board and to renegotiate the deal, presuming you've put into the original agreement a financing contingency clause that reads: *this contract is contingent on financing.* In this case, the bank's refusal to provide financing based on the agreed upon purchase price should allow for you to either renegotiate, if the seller is willing, or to walk away from the deal.

But if you don't want to walk away and yet the seller won't budge, you will have to make up this difference, making it necessary for you to put down $28,750 instead of $25,000.

This process did not used to be so much of a concern. But we are still in a declining real estate market in 2011/2012 and the banks are being very cautious. You might consider negotiating in the original agreement a purchase price contingent on appraisal, which is to say that if the bank appraises the property for less than the agreed-upon price, then you will pay whatever the apprised value is.

Closing Costs

Closing costs is another element for you to consider when speaking to bankers. Closing costs are simply the costs of getting the loan done. They include professional fees, such as attorney fees, survey fees, and appraisal fees, but they also include the finance fees that the bank charges you. When refinancing a property, if the appraised value is high enough the closing cast can often be wrapped into the loan, meaning that you don't actually need to bring the money to closing. But when purchasing, these closing costs have to be paid by you out of pocket, which makes them a tangible expense. This is why all things being equal, it is worthwhile to speak to multiple lenders to find the one with the most reasonable closing cost structure.

Amortization

Amortization is the process of paying-off a loan to $0 over a specified period of time. The formula includes three components, namely the starting balance, the interest rate which you are being charge, and the time-frame. The monthly payments on the loan depend on these three components. The longer the time frame the lower the payment. The higher the interest rate the higher the payment.

Most people are very concerned with the amount of interest they will pay the bank throughout the life of a loan. After all, if you finance $100,000 at 6% over thirty years, you will end-up paying the bank $116,000 of interest. I agree that if you are taking this loan out for your own personal residence, this should be a concern to you. To avoid paying so much interest you can do one of two things: you can either get a lower interest or, if that's not possible, you can shorten your amortization to 15 or 20 years. Let's consider the later.

On a thirty year amortization, your payment for a loan of $100,000 at 6% will be about $600 per month. If you shorten the amortization to 15 years, your payment will become about $843 per month, but this will lessen the amount of interest you will pay the bank over the life of your loan to about $52,500. The question is: are you willing to tie yourself up for an extra $243 each and every month in the name of saving about $63,000 over 15 years? I know this is real money, but let me give you perspective on this: which payment would you rather contend with if you lost your job or got down-sized? Personally, I'd feel safer with a lower payment.

Let me throw another log on this fire. In the world of income-producing real estate, our primary focus is cash flow, which is income minus expenses. With the mortgage payment being one of your largest expenses, it is typically desirable to keep it as low as possible. In the scenario that I described above, if you were to hold on to the $243 dollars of monthly savings, then in 5 years you would have $14,500 to use as down-payment for another building which, at 75% LTV, would enable you to buy a house for over $58,000 capable of generating $200 per month of cash flow. As a result, for the next five years you could save $450 per month (original savings of $243 plus the new cash flow). In five more years, you would have $27,000 to use as down-payment on a $100,000 duplex which will throw-off at least $400 per month of cash flow, growing your monthly savings to $850.

Thus, over a 15-year period you can choose to save $63,000 by electing a higher monthly payment, or you can parlay the savings resulting from a lower monthly payment into two investment properties generating a combined cash flow of $600 per month. Furthermore, the mortgages associated with these investment properties will be paid-off on your behalf by your tenants, and you will eventually own 2 properties free and clear. And chances are very good that those properties are going to represent three to four times more value than the $63,000 you could save on the interest. What do you think: Is this worth further consideration?

ARM Mortgage

Most of the mortgages out there utilize an amortization schedule whereby the interest rate and therefore the payment stays the same throughout the life of the loan. This doesn't have to be so. ARM stands for adjustable rate mortgage in which the interest rate can adjust at pre-disclosed point(s) in time throughout the life of the loan. For example, you can start out paying a 4% interest for the first three years, but then your rate will climb by 1% each year until it gets to 7%, and remain there for the rest of the duration of your loan. Or, you could have a loan with the interest rate that adjusts every 3 to 5 years based on the prime rate at that time. There are endless possibilities relative to how this could be structured.

As a real estate investor, you will need to learn how to work within the constraints of such loans simply because eventually your portfolio will become large enough that you won't be able to qualify for the fixed amortization loans. But you have to be careful. Interest rates adjusting upward mean your monthly payment going up, and unless you are prepared your cash flow can end-up in a world of pain. There are ways to address this reality, but that gets into advanced finance strategies for which now is not the time.

Balloon Mortgage

Balloon mortgage is any mortgage which incorporates a requirement of a *balloon payment* at a specific time, which is to say that the borrower is obligated to pay back the entire remaining principal balance at that time. For example, let's say you borrow $100,000 at 6% on a 20-year amortization with a 7-year balloon. In this case your monthly payment would be around $716, and after seven years you would still owe $77,475. When the balloon rolls around you would have to find a way to pay-back the lender the entire $77,475.

There are only two basic approaches to satisfy a balloon requirement. You can either organically pay-off the loan using your own money, or you can refinance. To pay-back organically, you would have to either amortize your payment an additional $745 every month for seven years, in which case the entire amount will be paid-off within seven years, or you will need to raid your savings and write a check for $77,475 at the end of year seven.

Since neither one of those options is particularly appealing, most people prefer to use the strategy of refinancing. But this could be dangerous because it is difficult to predict what the values will be in the future, and as you know, one's ability to refinance hinges on the appraised value.

Nonetheless, balloon mortgage gained considerable popularity over the last ten to fifteen years, because everyone including the banks was high on the idea that real estate values would continue going to go up indefinitely. As such, it was thought of as no big deal to assume that you can refinance a property in the future to satisfy a balloon. Unfortunately, when the real estate bubble burst and values started falling, a lot of people got stuck with mortgage balances that were greater than the value of their property, prohibiting any option of a refinance. This led to even more foreclosures, contributing to further decline in values – a vicious cycle.

Having said that, there is value to balloon mortgages in certain situations, but you have to be sophisticated about how and when you use them.

Conclusion

Your ability to surround yourself with people who are able to influence you in ways that move your agenda forward is one of the keys to success. The focus of this chapter was to learn how to speak to a traditional lender. As such, I did not touch in any meaningful way on any concepts or products relative to commercial or creative financing in this chapter. But now that you understand a bit of what is required of you relative to your loan application, and how to speak with a lender in a way they can relate to, it is time to get to work. Analyze your credit, income, and expenses. If everything is in line, pick up the phone and schedule a few appointments with lenders! If not, start fixing them! There is a misconception out there that creative finance does not require reasonably good credit and income potential. That's simply not true. What makes you think that a seller will finance a property for you, or that a private lender will work with you without looking at your credit report? They want to know that you pay your bills on time just the same as any bank! Creative finance simply adds horsepower to your engine of growth because it can be less restrictive and more reasonable. But you must have your affairs in order.