Foreclosures and Investors

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We hear it every day on the TV and radio, read about it in the papers, and see the results in our own neighborhoods: Real Estate Foreclosures are at an All Time High.

But what does that mean for us as real estate investors? How did we get here, and should we change the way we invest? Are some forms of investing more difficult in today's market? Are other opportunities opening up?

First, the mortgage lending market is going through a correction. Over the past few years, traders on Wall Street found ways to create more investment in sub-prime mortgages. Mutual funds and brokerages bought bundles of mortgage loans as investments. Instead of stocks, these brokers were buying groups of loans. They had computer models which predicted how many loans in each category would default, and based on those averages and models, many individual investors, mutual funds, hedge funds and institutional investors like pension funds invested in mortgages. The banks and big mortgage lenders made their money on the fees they charged to make the loans and then cashed out when Wall Street investors bought the loans. This created more available money to be lent, and less risk for the banks, so they lowered their credit requirements and offered competitive rates to borrowers, even those who didn't have good credit histories. And they also offered more money to each borrower. Instead of requiring borrowers to have 20% or even 10% of the purchase price to put down, they started offering one hundred percent loans, or combinations of first mortgages for 80% and second mortgages for the other 20%. Lenders also used adjustable rate mortgages and qualified the buyers for their loans based on the low introductory rates and payments.

More people bought and refinanced homes than ever before, and the people who invested in those mortgages made money, too. Then hurricanes hit, gas prices went up, more jobs went to places like Mexico and India where labor is cheaper, and more people defaulted on their loans. The variable rate loans started to adjust, increasing payments and housing prices stopped going up in many places from California to Las Vegas to Florida. This meant that like Pittsburgh, people in other places couldn't sell or refinance

their houses for a lot more money than they borrowed a few years ago. People owed more than their houses were worth, couldn't afford the payments, and were left watching the bank foreclose.
Now, people without really good credit can't borrow money easily, if at all. That means if you planned to flip properties at the lower end of the market, under $100,000, to people who had been renting and were buying their first home, you might want to change your strategy. Many of those potential buyers have less than perfect credit, and won't be able to get loans for 100% or even 90% of the purchase price. So you should plan your projects to have more than 20% profit on the back end, and expect to have to offer second mortgages to your buyers. Also make sure their first mortgage lenders know about your second, and it shows up as a seller second mortgage on the settlement sheet. If it isn't on the settlement sheet that goes to the first mortgage lender, you and the buyer are committing loan fraud.
Next, be prepared to make your money more slowly as an investor, instead of with quick flips. As long as you have good credit, you should still be able to get loans to buy and renovate properties, then rent them and refinance using the leases as evidence of cash flow sufficient to pay the term mortgage. Your rental income will increase slightly each year, hopefully faster than your payments increase, and you will build equity by paying down your loan and from appreciation of your properties. You also build a great retirement income, since the real cash flow from rentals comes after you pay off the mortgages, ten to twenty years down the road.
Until the mortgage market changes again, many people without great credit and down payments will be renters instead of buyers, so as long as you do a good job picking locations for the long term, do the right renovations, and screen your tenants carefully, you should build a little equity and increase your cash flow a little bit each year on each unit.
If you really don't want to be a landlord, a good middle of the road position is to "Rent to Own" properties to buyers who can't qualify for traditional financing, but can afford the payments. An installment land contract gives the buyer more of an interest in the property than a renter. The down payment gives you more than a security deposit, and in a year or two, if the buyer gets or keeps their credit clean, it is easier for them to get a loan to refinance their installment contract than it would have been for them to get a purchase money loan.
The reason for this is that lenders on refinances aren't looking at the purchase price, just the appraisal of the property. Also, lenders aren't

looking at how much cash the buyer is putting down, just how much equity the appraiser says they have at the time. So, if you have sold at a fair price, and the market value of the house increases at all, it should be easier for the buyer to get a loan. You just have to be more patient. But land contracts often require the buyer to maintain the property, so you shouldn't have as much to do while you wait as you would with a tenant.

I have some clients right now who are getting even more involved in foreclosures. They are finding people who are losing their homes not because they aren't employed or can't manage a reasonable payment, but because they are stuck in high rate adjustable mortgages or owe more than their homes are worth. The investor qualifies the owner to make a lower payment, based on a combination of the investor buying the property at a short sale, where the bank takes less than the amount outstanding on the loan, and the investor having better credit than the owner, and thus being able to get a lower interest rate. The owner can then stay in their home, either as a renter, a renter with an option to buy their house back at a fair price which also gives the investor a fair profit, or under an installment land contract. Look for more information on short sales and on the new seminar, "Can I Save My House?" elsewhere in this newsletter, and keep investing with your new strategies!

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