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Beyond the Rate – Chapter 9

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 9 and we'll be looking at some financing strategies for real estate investors who approach the market with more sophistication and very different objectives than the average homeowner.

My name is Patrick and I'm a Mortgage Banker here in the San Francisco Bay Area. I'm your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

Please note that the text versions of these podcasts are now available for free download at my website at www.beyondtherate.com along with a bunch of related materials and resources. You can also sign up for my monthly email newsletter and/or a quarterly mailer at the site.

Real estate investors can be broken down into one of three categories. And the distinctions between these categories are based on the length of time the investor wants to hold the property. On the short end of the continuum, you've got your "flippers". These guys are looking to get a property on the cheap, maybe put some money into fixing it up and then selling it for a profit. For the most part, they have no intention of renting the property out and work as quickly as possible to complete the deal. This category represents a lot of the folks chasing foreclosures and probate sales. From the lending perspective, their biggest motivators are low down payments and NO prepayment penalties. They'll even pay exorbitant Subprime interest rates to put these deals together without penalties.

Next up, you've got your speculators. These guys are looking for markets that are appreciating quickly. The idea is to get in, buy a bunch of properties, keep them for 3 to 5 years and then move on to the next booming market. For that length of time, they have to rent out their properties but are not particularly interested in paying down the principle balance on the mortgage. In fact, if they're confident in

the appreciation potential in the market, they may be willing to accept negative amortization loans in order to keep the cash flow on their properties positive.

The last category is the long-term investors. These guys are trying to accumulate a portfolio of properties and have the rental income pay down the principle balance over a period of time. The idea, obviously, is to own a number of properties outright or with minimal mortgages and enjoy positive cash flow on each. From the lending perspective, these investors are looking for longer term loan products like 5/1s, 7/1s or 10/1s – or even 30-year fixed mortgages. Clearly, a property with a 30-year fixed mortgage and a sustainable cash flow situation means the property will eventually be paid off, leaving just the property taxes and insurance as expenses.

So, let's talk about each of these a bit more.

Starting with the flippers, a lot of these people do this stuff full time. If they've got another job, it makes it a lot easier. But if they don't have a regular job, they don't have a verifiable source of income. Of course, if they've done it for more than two years, we can say they're self-employed and get the loan done that way. But if they're new at the game – and many of them are – we almost always have to use a No Doc program. If you remember from Chapter 3, that's the lowest level of documentation and the pricing reflects the increased risk.

Meanwhile, if we say they're self-employed, they obviously have an investment property as well as a primary residence – and maybe more than one – all without any rental income. So they're supporting two houses. That means we'd have to show a VERY high income to fit within debt-to-income limitations. The moral to the story is the vast majority of these deals end up in Subprime loan programs because it's easier to get approvals down there, particularly for a low or no down payment program.

Now, the question is: does it matter? Well, not really because you're only planning to keep the property for a few months anyway, so the monthly payment isn't that important. Yes, it might be a higher payment but you only have to make three or four of them (hopefully) before you can get out of it again. It's just another cost of doing business. By the way, I'm not saying A-paper and Alt-A programs are impossible for these types of deals. They're just harder to qualify for.

What about the speculators? The people who are buying for 3 to 5 years. Well, the negative amortization Option ARMs are extremely popular. Now, you've obviously noticed throughout earlier Chapters of this podcast series that I'm not a big fan of Option ARMs. I think they're very risky and largely misunderstood by those who get into them. The biggest attraction of these loan products is their low initial monthly payment but it's balanced by the negative amortization that results and an interest rate that's variable right from the very first month.

Anyway, they do have real value for speculative real estate investors because they make it more possible to have positive cash flow on an investment property. So we

should really take a moment or two to fully understand how they work. First and foremost, the initial payment is an artificial payment. In many cases, it's based on a 1% interest rate but that definition is based more on marketing than reality. Fact is, the minimum payment is less than the accrued interest so its exact value is largely irrelevant. The mortgage loan balance goes up either way.

But this minimum payment doesn't stay the same forever. It's fixed for the first 12 months and after that, it increases by 7.5%. Then it's fixed for another 12 months and then, it increases by 7.5% again. The minimum payment increases by 7.5% each year for the first seven years OR until the loan balance has reached its ceiling. Depending on the program, these loans can grow to either 110%, 115% or 125% of the original loan balance. Actually, the ones that can go as high as 125% are becoming increasingly rare. Most will only allow you to go as high as 110% or 115%. Anyway, once you've reach that ceiling, the loan starts amortizing right away – and that means a BIG payment shock at that point.

For obvious reasons, these loan programs are only justified if the real estate market is appreciating FASTER than the loan is growing. Although it depends on where interest rates go, most of these loan programs grow by 2% or 3% each year if you only make the minimum payment. So if the real estate market is appreciating faster than that, you're still making money. If not, you're losing equity every month. That's the scary part. If it ever comes to that, you actually SAVE money by selling today – unless you're okay making the larger payment interest only payment. And don't forget the interest rates on these programs are variable so the interest only payment can be different each and every month.

But we also have to keep in mind that these loan programs will only go as high as 90% financing. In fact, on investment properties, some lenders won't even go that high. Depends on the lender. Also, the 90% financing is generally split into two separate loans. The 1% start rate loan usually only applies to the first 75%. The 15% second mortgage is added to total 90% and it's usually a fully amortizing loan with a much higher interest rate. Sometimes, you can do an 80/10 but most are 75/15s. So that means you have to come up with at least 10% down payment to qualify for one of these loans. That makes it more difficult to buy more and more, unless you continuously refinance and take cash out of other properties.

The speculative investors who use these programs are trying to keep their properties cash positive, or as close to cash positive as possible. But as we discussed a moment ago, the payments rise by 7.5% each year. After three or four years, the payment will be 24% or 33% higher (respectively) than it was at the beginning. If the market is still appreciating strong at that point, the investor may want to keep the property for another three or four years and refinance into another identical loan product, bringing the payment back down to the initial 1% point again. Doing so would increase the negative amortization but it may also keep the cash flow positive on that property.

You see, you have to understand how underwriters evaluate investment properties. It really doesn't matter how much equity you have. They only look at the cash flow

impact of owning it. And you can show that impact in one of two ways. You can show lease agreements on the properties but the underwriters will always take the monthly rental figure and mark it down by 25% to account for periodic vacancies. It's called the occupancy factor and most loan programs give you credit for 75% of the rental income listed on lease agreements. Incidentally, many Subprime programs will give you 90% or even 100% of such rental income. Again, another example of looser guidelines in Subprime loans.

The other way to show the cash flow impact is with the Schedule E of your federal tax return. That schedule details the income you make from rental properties but you clearly have an incentive to reduce that income as much as possible to limit your tax liability. Meanwhile, for underwriting, you want to show as much income as possible. So there's a conflict there. Point is, there are disadvantages with both methods and you should usually look at both options to see which one will calculate the highest.

Each time you have a property that's got negative cash flow, you have to show more income to squeeze into the same debt-to-income limitations for the next loan. It makes sense if you think about it. If you're subsidizing a property with your own income, it represents a monthly expense just like a car payment. So each time you add another property that you have to subsidize, you have to show more income to qualify for the loan. Depending on how much you're subsidizing properties, that can quickly lead to situations where you're claiming more income than you actually earn OR the income you're claiming is no longer considered reasonable by underwriters.

If a speculator wants to continue accumulating properties in hot markets, one of his or her top priorities is staying cash positive, or as close to it as possible. That priority exists for long-term investors as well but so does the repayment of the mortgage balance. As a result, these investors tend to consider more factors than just annual real estate appreciation. Of course, that's attractive but so is a healthy rental market, and the rental market depends on the types of jobs available in the local area and the health of the local economy.

There are plenty of companies out there that study this type of information and provide various reports and ratios to help identify healthy markets. I'm sure you could go to Google and find a lot of these types of offerings. I recently read an article that chose Charleston SC, Jacksonville FL and Austin TX as particularly attractive markets for long-term real estate investments. All three cities have diversified economies, good wages and affordable housing. Anyway, the motivation is clearly different than speculators or flippers. Long-term investors want a stable market where they can cover an amortizing loan payment – that's principle AND interest – with the rental income from the property.

Now, a well planned real estate investment strategy may involve more than one type of investment. For example, a long-term investor may buy a property in a hot market using a negative amortization loan and keep the property for only three or four years. After realizing some appreciation, the investor may sell the property

and use the profits to pay down a mortgage on a different property in a more stable market. Perhaps the reduced mortgage balance will bring the property from a cash negative situation to a cash positive one. For the right investor, this strategy can work well even for flipped properties.

Of course, there are plenty of promoters out there encouraging people to take these profits and leveraging them even further into more and more properties. Many of these promoters encourage people to use negative amortization loans on all their properties. That's where I have to disagree. That would've been fine four years ago but I just don't believe the real estate market will continue to appreciate the way it has in recent years. Given the current market conditions, I don't believe it makes sense to expose yourself to that much risk. If the market goes sideways, these loans erode your equity and add volatility to the market.

There's always a balance. That balance will definitely be different for a sophisticated investor than it will be for an average homeowner but that doesn't mean you have to stretch it to the absolute limit. At the end of the day, the ideal situation remains; owning properties free and clear and collecting monthly rent payments on each.

Okay, so if you like what you hear on this podcast, please tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I am deserving of yours, my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I can. My office phone number is 925-465-1223. Again, that's 925-465-1223. You can also reach me by email at patrick@beyondtherate.com.

See you next time for Chapter 10. We'll be looking the future of interest rates. As discussed way back in Chapter 1, interest rates are determined by the supply and demand of investment capital in the bond markets and there are ways of forecasting that relationship far into the future. We'll take a closer look next week. It's fascinating stuff. Stay tuned.

Bye for now.