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Chapter 4

GET THE SCOOP ON...

Shopping for financing ▪ Finding the loan that fits you ▪ Fixed versus adjustable loans, plus other types of loans ▪ The difference between using a mortgage broker or going directly to a bank ▪ Understanding the closing process and knowing what to expect ▪ Working with the closing agent ▪ Understanding costs that are incurred during closing

Financing Rental Property

Understanding the entire financial picture and the escrow/closing process when preparing to purchase your investment property is an important part of your investment process. You need to know your financial options, how to take title, and what to expect from the time you apply for a loan until the title is recorded, and you "go on record" and officially own the property.

Before you start shopping for your first investment property or another investment property, take the time to know where you are financially. Meet with your accountant, and then meet with a mortgage broker or banker to find out what he or she is looking for to qualify for a loan for an investment property. Get pre-qualified so that you know where you stand financially prior to looking at and finding a property to purchase.

There are a lot of decisions to make after you find the property, make the offer, receive an accepted offer, and close the transaction. Take the time to know the process and what to expect before your clock is ticking and you are closing and have a limited amount of time. By doing your homework ahead of time, you can help eliminate some of the stress and get the best possible rate. If you don't shop around, you won't get the best loan.

Besides location of the property, the loan rate, terms, and conditions are the second most important things. A good loan can make the difference between success and failure in managing rental properties.

Not all lenders are alike. Some lenders like large apartment buildings and some like the smaller ones. In a competitive market, rates can vary in points and fees quite a bit. Most loans on investment property aren't the same as your traditional residential property or an owner-occupied loan. Your appraisal will also be more expensive, as well as the fixed costs and monthly expenses.

Sources of funding

There are many sources of money but really there are four main ones.

- Your local bank or savings and loan
- Mortgage broker
- Private-party lender (such as the current owner of the building your are purchasing)
- Hard money (see the "Hard money loan" section for details)

The Federal Housing Association (FHA) doesn't actually lend the money but are insurance industry lenders for the private mortgage bankers, banks, and savings and loans.

When you go to the money source, including the bank, you should know or have the type of building identified. The number of units makes a difference, along with the amount you want to spend and the amount you are qualified to spend.

Lenders want to be sure you'll have enough rental income to cover the mortgage payments, taxes, insurance, and maintenance. In some areas, you end up having to put down a larger down payment due to the price of real estate and the amount of income coming in. Lenders have strict guidelines that you need to know and follow. Not all of the guidelines are the same.

Residential loan (for one to four units)

There are many options that exist; more so if you are planning on living in the property or what the lenders call "owner occupied."

When the property is an owner-occupied property the lender usually requires 3 percent to 20 percent down. This can mean that you come up with the 20 percent or that you have the current owner carry back 10 percent as a second mortgage. It is important to check with the lender you are working with as to their lending policy regarding whether or not you can have a second loan. Some lenders absolutely don't allow a second loan. Don't be afraid to go to two or three lenders with the same loan packet. This way you have more options. If one lender says no, you can quite possibly get an approval from the second lender.

Check with your real estate property-management professional for a referral to a loan broker to help you understand and move through the process.

Sometimes, you may even be able to find a lender willing to do a 95 percent loan on an owner-occupied property. Putting down the minimum and having as much cash on hand as possible is always the best way to go. If something comes up with your building or if you have a chance to purchase the next investment property, having money on hand is important.

Bright Idea

When putting together your financial packet and loan application, making two additional copies really doesn't take much more time or effort. This is time well spent. By having the extra copies, you can easily submit your loan application to more than one lender.

If you have a loan for more than 80 percent, you could be required to have private mortgage insurance, which is also known in the business as PMI. This insurance is protection for the lender against foreclosure. There are more added costs when you are required to have PMI, usually with a higher interest rate, and you could be charged higher points to cover the cost of the insurance.

A point is something the lender charges on top of other fees, and it is equivalent of 1 percent of your loan amount. So if a lender charges you 2 points on $100,000 loan amount, that would be $2,000. You still have all of the other costs associated with the loan such as title insurance costs, lender fees, appraisal fees. It can quickly add up to a lot of money.

Commercial loan

Non-owner-investment property or a property with five units or more have to go the commercial loan route. You will quickly realize that it is a different ball game. A lender approaches a non-owner-occupied property (property you don't plan to live in) differently than one you will be living in. The rates and fees and the amount of down payment typically are higher. It is usually beneficial to go to a small lender who does investment property lending in the community where you are buying your property.

The down payment on commercial loans can run on average between 25 to 35 percent of the total purchase price as compared to residential loans. A requirement like a large down payment can put most beginning investors out of the market. This is why quite commonly you purchase a single family home or smaller property when you first get started.

Watch Out!

Don't hire just any appraiser, because not all appraisers are certified and approved by all lenders. You must be aware that each lender has approved appraisers. You must hire an appraiser who is approved by the lenders in your area. Large lending institutions even have their own in-house appraisers.

If you shop, you'll likely find several lenders offering 100 percent LTV (loan-to-value) loans, with varying interest rates and points on commercial and non-owner-occupied properties. However, commercial loans are always more difficult to qualify for and obtain than residential loans.

> "I recommend going to a small lender and meeting with somebody at the bank that makes the decisions. It will give you the basic answers you need to make a better decision."
>
> —Jack D., mortgage expert

As with residential rental properties, qualifying for an investment property of five units or more is primarily based on the ability of the property itself to generate a good, solid cash flow that will in turn be repaying your loan. The building you choose to buy should have income that can cover your monthly mortgage payments, pay your regular expenses, and have some cash flow left over for you as the investor to put into an account as a reserve for your maintenance costs.

Most loans on investment property aren't 30-year fixed loans. They are most often variable and amortized over 30 years but due and payable in 10. Talk to a mortgage lender for additional details.

Private-party lending

It never hurts to ask the current owner (that is, the seller) whether he or she would be interested in carrying back the loan with a smaller down payment and a fair interest rate. Oftentimes, you can save a lot of money in lending fees and you do not have to come up with as much money for your down payment.

Hard-money loan

A hard-money loan is good short-term financing if you are in a bind. This is when a third party makes a loan on the real estate as if he or she were the lender. Most of the time, a hard-money loan

Know Your Banker

A banker is an important person to know and have on your side. A good relationship with a banker only makes your business and rental investing easier. In fact, having a good line of credit available and a good financial advisor you can consult before you need a loan will make all the difference in a transaction.

Start building your banking relationships early on with a few different banks and a good mortgage broker you feel you can work closely with. Don't wait until you need a banker to build that relationship. When you establish a relationship early on with your banker, he or she will know your financial history and have most of your records in hand if you establish with a bank you use on a regular basis.

Not all transaction are the same, so keep your banker aware of what your plans are after you have purchased your first investment property and are looking for the next one.

is used because the buyer can't get financing from a conventional lender or at least not enough to close the deal. Sometimes, a hard-money lender is used due to the purchaser having poor credit or because the property intended for purchase is in complete disrepair and is a true fixer-upper.

Keep in mind that all financing is just a tool to get into the property. Oftentimes, in only a few short years, your value goes up and you can refinance and possibly get even a better loan with plenty of time to shop for the best rate and the best loan.

Prepayment penalties

Most commercial and some residential loans have a pre-payment penalty if you want a lower rate. This doesn't mean you should not go with a loan that has a pre-payment penalty; just know what your penalties are and how long you must keep the loan to avoid the prepayment penalties. Just be clear about what you are getting into.

Understanding what happens during closing

Congratulations! Your offer has been accepted! Now what? Knowing the process and what to expect is important, and having an understanding of the process will help things run smoothly.

Your real estate agent usually walks you through the process and oftentimes will attend your signing of all the papers. In some states, you sit at the same table with the seller, and everything is signed at the same time. Some states use a third-party intermediary, sometimes called an escrow officer. In others, you work with a lawyer to make sure all the documents are legally drawn and recorded. For example, in North Carolina, only members of the bar can examine the property's title, prepare legal documents, and give legal advice. Non-lawyers' participation in closings is very limited.

The rest of the chapter tells you what to expect throughout the process after your offer has been accepted.

The functions of a closing

Buying and selling investment/rental property usually involves the transfer of large sums of money. It is imperative that the transfer of these funds and related documents from one party to another be handled in a neutral, secure, and knowledgeable manner. For the protection of buyer, seller, and lender, the closing process was developed.

Closing (or escrow) is a transaction where one party engages in the sale, transfer, or lease of real or personal property while another person delivers a written instrument, money, or other items of value to a neutral third person, called an escrow (closing) agent or escrow holder. This third person holds the money or items for disbursement upon the happening of a specified event or the performance of a specified condition.

Bright Idea

After your offer is accepted, you may select the closing agent, who may be an attorney and/or an escrow intermediary. It is a good idea to get a recommendation as to which company to use and which closing agent colleagues and friends recommend.

Simply stated, the escrow holder impartially carries out the written instructions given by the people buying and selling the property. This includes receiving funds and documents necessary to comply with those instructions, completing or obtaining the required forms, and handling the final delivery at all times to the proper parties upon the successful completion of the escrow.

When all of the instructions in the escrow have been carried out, the closing can take place. At this time, all outstanding funds are collected and fees/charge are paid. Payment of funds at the close of escrow should be in the form acceptable to the escrow, because out-of-town and personal checks can cause days of delay in processing the transaction.

Even though the closing process may be called something different in your area, the basic procedures are the same.

When your offer has been accepted, it is time to open escrow. Information you will need when opening escrow:

- Your name and address and company name, if you are running things as a business entity
- Listing realty company, if there is one
- Address of the property
- Parcel number
- Sellers' and buyers' full names
- Sales price
- Brief terms (for example, concurrent closing or exchange information)

- Approximate closing date
- New lender's name and address, along with a contact person
- Special information, if you have any
- Old loan information: lender's loan number and mailing address

The next thing that will happen is you will receive a preliminary report. Take the time to read it. Look for red flags such as:

- The plot map covers a different lot.
- The address is different.
- Easements are shown on the parcel that you were not aware of.
- There are loans or liens you were not aware of.

Follow up

Following up to get the closing completed in a timely manner is very important. Stay in close contact with your Realtor, if you're using one. Be sure to mark your calendar as to what dates you have to have items completed or even when you must increase your deposit.

For the buyer

As soon as you have received an accepted offer and your contingencies are removed, start working with an insurance agent to obtain proper insurance. Also expect to receive an explanation of all closing costs and your new loan terms in the mail. Here are a few other items to double- and triple-check.

- Homeowner's insurance (usually the insurance agent provides the policy details and proof of insurance)
- Explanation of closing costs
- Explanation of new loan terms
- Double-check all inspections performed on the property

For the seller

The seller is responsible for providing the following items. Be sure the seller takes care of these items in a timely manner to avoid unneeded stress during the transaction.

- Order payoff statements.
- Order and clear all work or negotiate who will take care of what items from the property condition reports, contractor's report, or any other property inspections performed on the property for sale.
- Stay on track for closing and as the date gets close, make arrangements to sign documents at the escrow/title company.
- Have everything in order so that there are no last-minute surprises.

Understanding closing costs

So, it is the big day. The day you sign your name on the dotted line several times, hand over the check, and prepare to take ownership of your new property and become a "landlord."

This is also the day that the seller will pay closing costs, which is usually accumulation of separate charges paid to different entities for the professional service associated with the buying and selling or real property. You also have closing costs, usually to the loan company, for insurance and other professional services.

It can be a day filled with much anxiety, stress, and uncertainty. By being prepared and knowing what to expect, however, you will eliminate most problems and a lot of the stress.

When your offer is accepted, don't be afraid to ask your Realtor whether he or she has some material you can read to get familiar with the process and what to expect. If it is not your first time purchasing, it is still a good idea to refamiliarize yourself with the process that is ahead of you to take ownership of your new property.

Normally the buyer can be expected to pay for:

- Escrow fees
- Homeowner's policy of title insurance
- Lender's title policy premiums (ALTA)
- Document preparation (if applicable)
- Notary fees
- Tax proration (from the date of acquisition)
- Recording charges for all documents in buyer(s) name(s)
- Homeowner's insurance premiums for the first year
- Beneficiary statement fee for assumption of the existing loan (if applicable)
- Assumption/change-of-records fee for takeover of existing loan
- All new loan charges (except those required by lender for seller to pay)
- Interest on the new loan from date of funding to 30 days prior to first payment date

When purchasing property, everything is negotiable. Your current market dictates who will be paying for the different costs within the closing. All of the terms are put in writing and are negotiated in the very beginning. In many cases, the following are some of the fees the seller may pay:

Normally the seller can be expect to pay:

- Real estate commission (if applicable)
- Document preparation fees

Moneysaver

It feels good after you close to not have to make your first real payment on the mortgage for up to 45 days after the date of closing. It gives you some time to breathe and gather money for your first loan payment.

- Notary fees
- Any judgment, tax liens, and so on against the seller or the property that show up on title
- Homeowner's transfer fees
- Any unpaid homeowner's dues (where applicable)
- Any bonds or assessments
- Any and all delinquent taxes
- Documentary transfer tax (if applicable)
- Any loan fees required by buyer's lender
- City or county transfer tax (may be split with the buyer)
- Recording charges to clear all documents of record against seller
- Tax pro-ration (for any taxes unpaid at the time of transfer of title)
- Payoff all loans in seller's name (or existing loan balance being assumed by buyer)
- Interest accrued to lender being paid off, statement fees, reconveyance fees, and any prepayment penalties
- Security deposits (the seller will be debited all tenant security deposits, as well as any prepaid rent collected prior to closing)
- Any other items that were to be held back for repair within the contract

Keep in mind most fees are negotiable in advance and will be spelled out on the purchase agreement.

The role of the closing agent

The closing agent, sometimes referred to as an escrow officer, serves as a neutral party. An attorney may be able to serve as the neutral party, depending on the state and the laws. Either way, this person prepares all the paperwork and sees the transaction through until it has closed, disbursing all funds and giving a final accounting after the close of escrow. He or she also oversees the signing of all legal documents.

- Serves as the neutral "stakeholder" and the communications link to all parties in the transaction
- Prepares closing instructions
- Requests a preliminary title search to determine the present condition of title to the property
- Request a beneficiary's statement if debt or obligation is to be taken over by the buyer
- Complies with lender's requirement, specified in the escrow agreement
- Receives all purchase funds from the buyer
- Prepares and secures the deed or other related documents
- Prorates taxes, interest, insurance, and rents according to instructions
- Secures releases of all contingencies or other conditions as imposed on any particular closing
- Records deeds and any other documents as instructed
- Requests issuance of the title insurance policy
- Closes escrow when all the instructions of buyers and sellers have been carried out
- Disburses funds as authorized by instructions (in writing), including charges for the insurance, recording fees, real estate commission, and loan payoffs
- Prepares final statements for the parties accounting for the disposition of all funds (these are useful in the preparation of your tax returns)
- Sits with you while you are signing and explains and answers any questions you may have
- Calls you to let you know you have "gone on record." Congratulations you are the new owner of the property!

The closing agent may not be able to offer legal advice, negotiate the transaction, or offer investment or tax advice. He or she is the neutral party and cannot offer advice.

Just the facts

- You have options when it comes to financing your property; be sure to take the time to shop your options.
- Your banker is your friend. Take the time to get to know the key people who are in the loan department at your bank.
- Understanding the entire process of applying for your loan is important.
- There are many different sources of money, but four main ones.
- A hard-money loan can be costly, but if it is the difference between purchasing the property or not, it may just be worth the extra cost.
- How you hold title helps minimize taxes and protects your assets.
- Your loan options change when you purchase a property of five units or more; it becomes a commercial loan.
- Some loans have prepayment penalties if you pay them off too early.
- Thoroughly investigate legal documents before you sign the loan.
- Understand what the closing agent does and what is expected of you ahead of time.
- Make a checklist of everything you will need when you close.
- All terms of who pays what are negotiated at the time of making your offer.
- Find out how closing is done in the state where you're buying your property.