

THE INSIDER'S GUIDE TO MORTGAGES

All the information you need
to confidently navigate the
home loan process

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Visit our website at www.sfmortgage.com for updates to this book, current mortgage news and additional resources such as calculators, online application, and links.

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About this book

As a companion to our website at www.sfmortgage.com, this book is designed to guide you through the complex world of mortgage finance, explain your options, and help you select the right mortgage. Understanding the wide range of mortgage choices available and evaluating them in terms of your financial goals and needs is a complex but financially rewarding task. The entire guide and all our resources are available to you—online, by e-mail, or by phone—without obligation.

The SFMortgage team is part of All California Mortgage, a Diamond Certified™ mortgage lender serving the bay area since 1992. We have worked with first-time homebuyers and retirees, single parents and CEOs, growing young families and empty nest couples, investors and vacationers. We use our experience to make your loan process simple and easy. You are welcome to contact us with questions, for a consultation, or for a pre-approval.

We look forward to hearing from you!

About the author

Richard Redmond, the founder of the SFMortgage team, has been a residential mortgage broker at All California Mortgage in Larkspur Landing since 1992. In the last five years he has helped his clients with over 700 transactions, funding more than \$350 million in mortgage loans. These were purchase and refinance loans for single family homes, condominiums, live/work lofts, second homes, and investment properties; home equity lines of credit and second mortgages; and loans for the purchase of land, for construction, and for bridge financing.

About SFMortgage.com

Visit us at our website, www.sfmortgage.com. In addition to updates to this book and current mortgage news you will find calculators, an online application, links, and other useful information and tools.

How do I shop for a mortgage?

There are two ways to climb the mortgage mountain: with a guide or on your own. Take the one that feels more comfortable for you.

1. The simpler path is to choose an experienced professional early in the process, and let that person be your advisor. If you choose wisely, you will end up with a mortgage package as good, or even better, than that of someone who spends a great deal of time shopping many different lenders. You may decide on a loan officer at a bank or credit union, a mortgage broker, or an online lender. For advice on finding the right person, and what they'll need to know to give you the best advice, go to "**How do I find a good lender?**" below.

2. Your other choice is to investigate multiple options, analyze many different programs, and contact a range of lenders—at least one bank, one mortgage broker, and one online lender. If a more hands-on, self-directed program is what you are looking for, "**How do I compare mortgage offers from different lenders?**" on page 9 will guide you through that process.

Choosing the right shopping strategy and following the steps outlined here is a good investment. Lowering the interest rate on a \$400,000 loan by one quarter of a point will save you over \$5,000 during the first five years of your loan. The advice in *The Insider's Guide to Mortgages* will help you find the lowest rate on the mortgage that best matches your current financial situation and your long-term financial goals. It will also save you from finding out at closing that the loan terms or fees you were expecting had changed.

How do I find a good lender?

Having a good mortgage lender—a bank or savings & loan, an online lender, or a mortgage broker—can not only make the mortgage process easier, it can also save you a great deal of money. Here is how to choose the right lender:

Talk to people you know. Real estate agents usually have one or more competent, professional lenders with whom they regularly work. Another professional you work with—a financial planner or accountant, a stockbroker or an attorney—may also know a reputable lender. You may want to ask a friend, neighbor, or co-worker who has just purchased or refinanced a home. Or you may be familiar with a lender whose advertising you've seen.

Check with a direct lender you work with—a bank, a local savings and loan, or a credit union. Remember, there may be some limitations in working with a direct lender. Most lenders have a relatively limited range of loan products, and, out of the 40-plus local lenders in the Bay Area, you will need luck to find the one with the most competitive rate and terms on the type of loan you have chosen.

Call at least one mortgage broker. A good mortgage broker will have a working relationship with at least fifty different lenders—we work with over eighty lenders—including almost all local, regional, and national banks and savings & loans. Lenders discount their loans to mortgage brokers. A borrower does not pay more to use a broker, and often pays less. Mortgage brokers have other wholesale sources not available to individual consumers. Borrowers save money when a broker shops many different lenders for the lowest rate and fees. A broker is especially valuable if you have an unusual scenario.

If you are shopping with online lenders, be aware that the rates published online are often for loan programs which have very tightly defined criteria that few borrowers meet. Online lenders generally cannot provide the knowledge and feedback that might help you make the best choice among the wide range of mortgage options. Also, some online lenders have developed a reputation for not providing the rates advertised; one of the largest online lenders, bankrate.com, has been in litigation over 'bait and switch' advertising on its site.

Interview more than one lender. You need to feel comfortable with the lender you choose. You want a lender who asks probing questions, listens to your answers, and presents you with intelligent options.

Also, reading “**What does a lender need to qualify me and provide an accurate rate quote?**” on page 10 and having the Buyer’s Worksheet, on page 53, or the Refinancing Worksheet, available on page 67, will help.

Of course, we would like to talk to you. We know that this book gives you an idea of who we are, but when you call you will find us to be responsive and informed—and very competitive.

How do I compare mortgage offers from different lenders?

If you want to effectively compare what different lenders have to offer, asking the question “What is your rate?” isn’t going to work. There is no simple answer to that question, because it depends on a host of factors, including; how long the rate is guaranteed (the rate-lock); if there is a prepayment penalty on the loan; what your property is worth (loan-to-value); what your credit score is; and whether you will qualify based on your reported income and assets.

To shop for a mortgage and compare lenders you have to ask the right question, which would sound something like this: “What rate can I lock in today for thirty days on a cash-out refinance for a \$500,000, 30-year fixed rate mortgage, with no points and no prepayment penalty; my property will appraise for at least \$800,000, I want to state my income and my assets, and my middle credit score is 742; I want to know all the lender and broker fees; and, of course, I want the quote in writing.”

This may sound like a lot, and if it does, we’re here to help—just contact us and we can walk you through any step in the process. Once you are ready to pop the question, knowing whom to call is as important as knowing what to say. **When you ask the right question to the right people, the rate and terms you are quoted will be clear, accurate, and comparable.** The three sections that follow will provide you with guidelines for quickly gathering the information you need to ask the right questions, and for finding the right people to talk to.

Choose the loan type and terms

Choosing the type and terms of your mortgage loan is an important financial decision. Although you may already know that you want a 30-year fixed, or an Option ARM, review **“Which is the best loan for me?”** on page 17 to help make sure all of the terms of the loan—prepayment penalty, interest only, points, etc.—are the right ones for you. It is also a good idea to talk to an experienced mortgage broker or lending officer to explore the ramifications of your available choices.

Know your situation

You must make sure that you understand your particular situation from the lender's point of view. You need to know your credit score, and how a lender will view both your income and your assets. **“What does a lender need to qualify me and provide an accurate quote?”** below tells you what information you need to provide and how to get it.

Ask the right people

When you want to compare mortgage offers, start by talking with a mortgage broker and a direct lender with whom you have worked before, or who have come recommended. **“How do I find a good lender?”** on page 7 will provide you with some guidelines for deciding whom to call. Make sure that all of your communication about rate and fees, and the rate lock, is confirmed in an e-mail.

What does a lender need to qualify me and provide an accurate quote?

Providing accurate information to a lender is the only way to get precise, useful feedback about the terms and interest rates of the loans for which you qualify. Also, remember that there is no such thing as ‘the rate.’ Loans are priced according to many different criteria; while each lender uses the same information, each one evaluates that information differently. To shop for a mortgage effectively, use the Buyer's Worksheet on page

53 or the Refinance Worksheet on page 67 to aggregate this information. Here is a list of what you need to know. **Each topic is explained in more detail on the following pages.**

- **Middle Credit Score:** A tri-merge credit report gives you the scores from the three major credit bureaus, Experian, Trans Union, and Equifax. Lenders use the middle of those three scores. You can get a copy of your tri-merge report by contacting us.
- **Employment status:** What do you do for a living? Lenders want to know whether you are salaried or self-employed, how long you have been in your current position, and how long you have been in the same line of work.
- **Income:** If you are going to document your income you will need to have your two most recent pay stubs and W-2s if you are salaried, or your last two tax returns if you are self-employed. Some borrowers choose to state their income; if you are stating your income lenders will not ask for income verification, but will still verify your employment status. Your mortgage broker or loan officer may be an important resource in guiding you through this part of the process.
- **Assets:** You need to provide account information for your seasoned liquid assets, and retirement account assets. Liquid assets include cash and money market funds, mutual funds, and stocks and bonds; generally, these assets are considered seasoned if they have been in your account for at least 60 days.
- **Property type:** Primary types are single family residence, units (duplex, triplex or fourplex), low-rise condominium (4 stories or less), and high-rise condominium (greater than 4 stories).
- **Other property:** Lenders want to know if you own investment property or a second home. If you do, lenders need to know property value, mortgage amount and payment, and property taxes and insurance for each property.

Credit score

Dealing with credit issues and understanding your score can be one of the more challenging parts of the mortgage process. As outlined below, **it may be possible to rapidly improve your credit score**. Providing documentation disproving a derogatory item and/or paying credit balances down are the primary avenues for raising your credit score quickly.

Know your score

The mortgage world often seems like an Edvard Munch painting—many shades of grey, the occasional scream. A credit score that warrants a higher interest rate at one lender may be fine for another. Some lenders give a break for a score above 780; several give preferential pricing over 740; and even more consider 720 good enough for a small price break. Some will not allow a borrower with a score below 680 to qualify for premium programs; for others it is as low as 620 for a borrower who meets other qualifications. This is why it is important to know your credit score and to shop your mortgage to a wide range of lenders—something that can most effectively be done by a good mortgage broker.

An important caveat: often when you are straightening out a derogatory item or reducing a balance, your creditor will tell you that the updated information will be reported to the credit agencies. Sometimes the information is updated, sometimes it's not, and it can take as long as three months for the updated information to be reflected on your credit report. If you feel it would help you to increase your credit score, it may be possible to do so in as little as five days by going through a mortgage broker or lender with direct access to the credit bureaus. **Make sure when you contact a creditor about a derogatory item or about lowering your balance, you always receive the new status of your account in writing.** With that in hand, your mortgage broker or lender should be able to get the item changed, and the credit score raised quickly.

Employment status

For loan purposes, if you receive a W-2, you are an employee, unless you own more than 25% of the company that employs you. You are considered self-employed if your income is reported on a schedule C, if you own more than 25% of the company that employs you, or if your primary source of income is from a partnership, reported on Schedule E. If your partnership interest is greater than 25%, or in some cases even 10%, you may be asked to provide partnership tax returns; some borrowers, or their partners, are uncomfortable with that (confidentiality is one reason that many people choose a stated income loan, and avoid providing this information). If you are an investor with at least a three-year history of investment income—dividends, interest, and/or capital gains—or a two year history of receiving rental income, you are also considered self-employed.

Most problems with employment status usually concern self-employment.

Most lenders want to see that you have been self-employed for at least two years, although there are some exceptions. A doctor who has gone from working in a hospital to opening a private practice, or a corporate IT manager who is now a computer networking consultant, are looked upon more favorably than a software engineer who has become a real estate agent, or a flight attendant who has become a landscape designer.

Proof of self-employment is also critical. Most lenders will accept either:

- Two years of business licenses
- A letter from a CPA who has been preparing your taxes for at least two years and will state that during that time you have been self-employed filing schedule C

If neither of those choices are an option some lenders will accept alternate documentation, for example letters from at least two clients who have worked with you for at least two years. Mortgage brokers know which lenders are more lenient. **Being employed is not necessary to obtain a mortgage loan.** Many lenders have 'no doc' programs that provide loans based only on your credit and the property. It is important that if you are not employed, have only a short time on the job, have a gap in employment, or are newly self-employed, that your lender know early in the process.

Income

Income determines your debt-to-income ratio, which is a primary factor in determining your qualifying loan amount. **How a lender looks at your income may be the most problematic aspect of qualifying for a loan.** One example: many people buy a new home before their old one is sold, often using an equity line on the old residence to purchase the new one. When figuring the debt-to-income ratio for the new purchase, adding in the debt on the old one can make it impossible to qualify, and most lenders do add it in. There is, however, one lender who won't count the trailing house when figuring the debt-to-income ratio if the house is listed for sale. There are several others who will remove the payment on the trailing house when figuring debt-to-income, but only if it is both listed and in contract. If you are uncertain about how a lender will look at your income, a good mortgage broker should be able to accurately assess your situation and give you options, as well as the perspective that comes from working with many different lenders.

The most important caveat regarding income:

If you are self-employed and doing a full-documentation loan, the lender is going to use your net income after all expenses—line 12 on the first page of your 1040—not your gross income. Also, if you are salaried, different lenders may look at your W-2/pay stub income differently if you receive substantial commissions or bonuses, or have had sharply declining or increasing income. Remember, if you own investment property or a second home that generates income, a lender will only give you 75% of the property's current rental income. **It is very important that your lender know your income situation up front, so that there are no unpleasant surprises down the road.**

Assets

The most common asset issues have to do with **seasoning**, and with **reserves**. **Seasoned assets are funds that are deposited in your account for at least 60 days.** Generally, if you are purchasing a home, a lender will want you to have 5% of the purchase price in seasoned

funds but, as always, there are exceptions. Lenders do not want to see any large unexplained deposits into your account or they become concerned that you may be borrowing money, taking on additional debt that has not been disclosed on the loan application. You can provide two months of statements to demonstrate a consistent seasoned balance, but there should not be any large deposits on those statements, unless they can be explained to the lender. Nowadays, lenders are much more liberal with allowing substantial gift funds from a family member, which do not have to be seasoned.

Reserves are the funds that you will have after the transaction is complete, whether it is a purchase or refinance. Depending on the lender and the loan program, reserve requirements will be based on one of three criteria:

- Amount of your total monthly housing expense: mortgage, taxes and insurance
- Amount of your total monthly debt: housing expense combined with your total monthly consumer debt (credit card bills, car payment, installment loans, etc.)
- Amount of the gross monthly income listed on the loan application

The lender will want you to have a certain number of months of that amount in reserve. Keep in mind that lenders will count only 70% of your retirement assets toward the reserve requirement. You need to let your lender know very early in the process if you are self-employed and planning to use funds from a business account. Also, some lenders will allow you to use the cash you are taking out in a refinance or from a home equity line for reserves, others will not.

Property issues

You will want to let your mortgage professional know of any unusual situations with your property, for example if your property is:

- In the middle of construction or remodeling
- A live-work space

- Multi-use: a condominium building with retail or office space
- Condotel: a vacation condominium complex that allows short term rentals
- On a brick foundation
- On a septic or well if not typical for the area
- A condo project in litigation
- A condo project with more than 30% of the units rented
- Clouded with title issues—tax liens, mechanic's liens, lis pendens, etc.

Other real estate owned

Your mortgage lender will want to know if you have any other property loans not listed on your credit report.

- If you are listing a property as having no mortgages, the lender will want confirmation by getting a property profile from a title company.
- If you're listing a rental property with income on your application, but either show no income from that property on Schedule E of your tax return or are taking a mortgage interest deduction for that property as a second home, lenders will want an explanation—which they may not accept.
- If you want to use your rental income to qualify, remember that lenders will use only 75% of the current monthly rental income less expenses.

Note: Lenders have become careful about scrutinizing second home purchases. They want to avoid providing a relatively low, second home interest rate to a borrower who is really buying an investment property. The second home has to make sense—especially its location and amenities. Lenders are also on the lookout for people buying a property as a primary residence when their intention is to use it as a rental. If you are buying down (purchasing a property whose value is less than the one you currently own), buying a 2-4 unit property as owner-occupied, or already have more than one investment property, you may have to clearly explain your reasons for claiming the new property as your primary residence.

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Which is the best loan for me?

These guidelines will apply to borrowers with typical loan scenarios. Out of the 80+ lenders with whom we work, many have niche loan products for borrowers who have unusual situations.

There are four primary loan types:

- **Fixed-rate mortgages** have an interest rate fixed for the life of the loan, usually 15, 30, or 40 years
- **Hybrid mortgages** are 30-year loans that have an interest rate fixed for 3, 5, 7, or 10 years before the loan becomes adjustable
- **ARMs**—adjustable rate mortgages have an interest rate that adjusts monthly, quarterly, semi-annually, or annually
- **Negative amortization ARMs** are either Option ARMs—ARMs with negative amortization, or Fixed Pay ARMs—hybrid loans that have negative amortization

Each of these loan types is available with the option of making an interest only payment; some may have the option of a prepayment penalty. They are discussed in more detail in the following pages.

How long do you think you will own the property?

This is the first question to ask when deciding on a type of loan. If you are reasonably certain of the answer, simply matching the fixed period of your loan term to that length of time using a hybrid mortgage is generally the best way to go. Normally, the longer the fixed term on a hybrid loan, the higher the interest rate. A hybrid fixed for 5 years will have a lower rate than one fixed for 7 years, and a hybrid fixed for 7 years will have a lower rate than one fixed for 10 years.

What if you don't know how long you will be in your house?

The only way to know which type of mortgage is the best for you is with a crystal ball. If interest rates drop and stay down for a long period of time,

you will be better off with an adjustable; if the opposite happens you will be better off with a hybrid or a fixed.

If you are not sure how long you will be in your home, or if you believe that you will be in it for a long time, choosing among fixed rate loans, ARMs or hybrids has two components: practical considerations and your risk profile.

Practical considerations

There are a number of practical reasons why you may need an adjustable rate mortgage or a hybrid. Most of these loans allow you to qualify at a lower interest rate than the prevailing fixed rate. This may be essential to be approved for the loan amount you need to purchase the house you want, or to refinance your current mortgage. Another practical consideration is current cash flow—you may want the short-term advantage of the lower monthly payment that you get with an ARM because you need extra money now for whatever reason—taking time off from work, expanding a business, or making an investment. An impending liquidity event—for example an IPO, a large bonus, or an inheritance—may be another reason to opt for an ARM.

Your risk profile

If you are not very certain about how long you will be in your home, and if you don't have a practical need for a hybrid or an ARM, the most important factor in determining which type of loan is better becomes your willingness to accept the risk of a potentially higher mortgage payment in the future in return for a lower initial interest rate and payment. If you opt for an ARM your payment might be much lower initially than the payment on a 30-year fixed, but the payment might be much higher two or three years in the future. Choosing a hybrid loan is less risky, especially if you choose one with an interest rate and a payment fixed for 7 or 10 years. Your worst-case scenario with an ARM or hybrid is simple to quantify—if the loan goes to its life cap, what will your monthly payment be? Although you may believe it is unlikely to occur, are you willing to take the risk of being locked into an ARM through a long period of high interest rates? You may want to read “**What are interest rates going to do in the future?**” on page 37.

The key is in knowing yourself

If you are a risk taker and are willing to pay the price if rates go up, then the ARM may be right for you. If you don't want to gamble with your home mortgage or know that if the adjustable went to its life cap you would be financially squeezed, stay with the hybrid or the fixed rate loan.

Remember, if you get a hybrid or a fixed rate loan and interest rates do fall, you can always refinance. Lender rebates have made it possible to refinance with most of the closing costs paid by the lender.

What are the advantages of a fixed rate mortgage?

Fixed rate mortgages have an interest rate that is fixed for the life of the loan. Most fixed rate loans also have a payment that does not change during the loan term, and with each payment you pay interest, and some principal. Fixed rate mortgages which have an option to make an interest-only payment during the first ten years of the loan are discussed below. With a fixed rate mortgage, at the end of the loan term the loan has been paid off. The word mortgage comes from Old French, and literally means a pledge that dies.

Advantages

- **Predictability**—the payment does not change
- **Security**—the interest rate can never increase
- **Saving**—each month you build more equity in your home as your principal balance decreases

Disadvantages

- **Higher rate**—rates are higher for fixed rate mortgages than for ARMs and hybrid loans
- **Higher payment**—hybrids, interest-only loans, and ARMs will usually cost less each month

- **Inflexibility**—with a fixed rate loan you must pay principal each month; you do not have the option of making a lower, interest-only payment

For many Americans the 30 year fixed is an icon, and anyone who chooses another mortgage option is a wild-eyed financial gambler. It's not that simple. **Paying principal on a mortgage is not magic—it is a forced savings plan at a relatively low interest rate.** This was very important many years ago when most people lived in the same house their entire lives, and before the advent of 401(k)s and IRAs. Today, as part of an overall financial plan, it can still be a good idea. However, I have many clients who are already contributing to a 401(k) or IRA, and who have other savings vehicles; they believe they are better off paying into a tax-advantaged 401(k) or IRA, or putting money in a high-return investment, rather than paying down the mortgage, and so they choose to pay interest-only. Over time they are confident that they will still build equity as their property appreciates, whether or not they are paying principal on their mortgage each month.

The most common fixed rate mortgages have terms of 15, 30, or 40 years; 10 and 20 year fixed are offered by some lenders as well. The interest rate increases slightly with the length of the fixed period—a 40 year fixed will have a slightly higher rate than a 30 year, a 30 year will have a slightly higher rate than a 15 year. However, the monthly payment increases sharply with a shorter fixed period.

- a \$500,000 loan fixed for 15 years at 5.375% will have a monthly payment of \$4052
- a \$500,000 loan fixed for 30 years at 5.75% will have a monthly payment of \$2918
- a \$500,000 loan fixed for 40 years at 6.00% will have a monthly payment of \$2751

Many lenders also allow you to make an interest only payment for the first ten years that you have a fixed rate loan. With a 30 year fixed, you would have 10 years at a relatively low payment, but for the last 20 years the payment would be substantially higher:

- a \$500,000 loan fixed for 30 years at 5.75% would have an interest only payment of \$2396 for 10 years, over \$500 less than the amortizing (principal & interest) payment of \$2918. However, beginning with year 11, the payment would jump to \$3510—a 68% increase in the payment in one month. That is a big increase, but it is only a 4% annually compounded increase in the \$2396 payment; in other words, if your income increases by 4% a year over the ten years, the payment jump should be affordable.

Also, if you choose the interest-only option, you can always pay as much principal as you choose each month.

What about hybrid loans, those fixed for 3 to 10 years?

Hybrid loans have an interest rate that is fixed for three, five, seven or ten years. These are sometimes referred to by names like ‘five-year fixed’ or ‘7/1 ARM’. They are called hybrid because they combine characteristics of fixed rate mortgages and adjustable rate mortgages (ARMs). At the end of their fixed interest rate period they become ARMs.

Advantages

These loans can provide a substantial saving over a 30-year fixed loan during their initial fixed period because they have a lower interest rate than a 30-year fixed. Generally, the shorter the fixed period the lower the rate and the greater the spread between the hybrid interest rate and the 30-year fixed interest rate.

Why you may choose a hybrid over a fixed-rate loan:

- You believe that you will only be in the property for a short while—3 to 10 years—and want the lower interest rate from the hybrid knowing you will be out of the property before it becomes an ARM
- You understand the cyclical nature of interest rates and believe you will be able to refinance at a lower interest rate before the hybrid converts to an ARM

- You need the lower payment that comes with the lower interest rate of the hybrid

If you are considering a hybrid, **always compare the interest rates among different hybrids—a 5-year, a 7-year, and a 10-year—and between the hybrids and the 30-year fixed.** This is important because the interest rate varies between different hybrids, and between a given hybrid and a fixed-rate loan, depending on current conditions in the financial markets.

For example, if the difference in interest rate between a 5-year fixed and a 30-year fixed is only one-quarter of a point—less than \$100 a month in most circumstances—you may prefer the greater security of the 30-year fixed. However, if the difference is one percent in rate—a payment difference of hundreds of dollars—you might feel that the interest rate risk that you take on with the hybrid is worth the reward from the lower payment.

Also, when you are comparing hybrids, don't just look at the initial interest rate. If you end up keeping the mortgage longer than you had planned, the adjustable rate loan that your hybrid converts to will be important. Check the index, the margin, and especially the life cap.

Disadvantages

Your risk with these loans is that you may end up staying in the mortgage longer than you had planned, and then are stuck with a hybrid that has converted to an ARM at a high interest rate.

Important considerations:

- If you are fairly certain about how long you will keep your mortgage, your best choice will almost always be the loan whose initial term matches the length of time you think you will have that mortgage. If you're likely to move in three years, you would opt for a loan fixed for three years; if you know you'll be starting a family in five or six years and moving to the 'burbs, you might opt for a 7-year fixed. A 6-month or 1-year ARM might be the right choice if you know you are going to be refinancing in a year or two when you complete a major remodel.

- The variation between the interest rate on hybrids of different terms, and between hybrid rates and a 30-year fixed, can vary dramatically depending on the market's expectation of future economic activity and inflation. As I write this, December of 2006, the interest rates on a 3-year fixed, a 5-year fixed, a 7-year fixed, and a 10-year fixed are separated by one quarter of a point in rate; the interest rate on a 30-year fixed is only one-quarter point higher than the 10-year fixed. This is because the market expects inflation to be tame and the economy to slow. In a normal market, the spread will be much wider. For example, in 2000, the spread between a 3-year fixed and a 10-year fixed was over one percentage point. This is important; if the difference between the hybrid and the fixed is very small—one-quarter of a point—you may choose to opt for the security of the fixed. If the spread is one or two percentage points, the hybrid may be more attractive, depending on your tolerance for risk and how long you think you will have the loan.

A word of caution

Beware of loans with stunningly low payments that claim to be ‘fixed’ for five years. These are actually negative amortization loans that have a minimum payment—not interest rate—fixed for five years. However, the interest rate can adjust frequently and is usually much higher than the interest rate on a 5-year fixed. You can make the very low minimum payment, but your loan balance will be getting bigger each month. See “**What about negative amortization loans?**” on page 26 for details.

What about adjustable rate mortgages, or ARMs?

Note: *negative amortization ARMs are discussed in the next question*

An adjustable rate mortgage, or ARM, is a mortgage loan with an interest rate that is periodically adjusted up or down. Adjustable rate loans are based on an **index**, a widely published benchmark interest rate, to which a **margin** is added. The most common indexes are the

12-Month Treasury Average or MTA, the prime rate, the LIBOR, and the 11th District Cost of Funds. ARMs have an **adjustment period**; some have an interest rate adjustment every three months, others every six months or every year. At the adjustment date, the margin is added to the current value of the index in order to determine the new interest rate that the loan will have until the next adjustment date. This new rate also determines your payment until the next adjustment date.

In order to protect you from runaway interest rates, most arms have an **adjustment cap** and a **life cap**. If your adjustment cap is one point, your interest rate cannot change more than one percentage point at the adjustment period, either up or down, regardless of where the index has moved. The life cap is the maximum interest rate your loan can ever have, regardless of how high the index is at the adjustment period.

The **start rate** is an introductory rate offered by the lender for a period as short as one month or as long as one year. This start rate can be much lower than the interest rate determined by adding the index to the margin. Once the start rate is over and the interest rate used to determine your payment is the index plus the margin, you are paying a **fully indexed rate**.

Which is more important with an ARM: the margin, the start rate, or the life cap?

Let's start with margin. The margin is the number that, when added to the index, determines the interest rate of an adjustable rate loan. For example, assume you have a 12-Month Treasury Average ARM that adjusts annually with a margin of 2.75%. Each year on the adjustment date the interest rate will be refigured, and that will be the basis for your payment for the next twelve months. On each adjustment date, the lender will add the margin of 2.75% to the index. For example, if the 12-MTA is 6.00% on your adjustment date, your interest rate for the next twelve months will be 8.75%; if it is 7.25%, your rate for the next twelve months will be 10.00%.

After your loan has become fully indexed, and within the limits of the life cap and the adjustment cap, the margin determines your interest rate for as long as you have that mortgage. For example, let's

take two borrowers whose loans have the same start rate and identical terms, with one exception—one has a margin of 2.50% and the other has a margin of 3.00%. The borrower with the 3.00% margin will be paying a half point higher interest rate for the entire period of the loan, except at the very beginning, because the start rates are the same, and when the loan is at its life cap.

Many borrowers will opt for a loan with a high margin in order to save a little on the start rate, or a half point in loan fee. This may be the right choice if you know you are only going to have that loan for a very short time, no more than three years. However, if there is a reasonable chance that you're going to keep the loan for a while, the margin is very important.

What about the start rate?

You have seen screaming headlines that say “1.25% Start!” Start rate is pretty obvious, but deserves a note of caution. Don't be seduced by a low start rate into a loan you may be sorry to have down the road. Consider the implications—what will you be paying two years from now, and are you comfortable with that?

Also, **figure how much that low start rate may cost you in the future.** With a higher start rate you might get a lower margin, which would be worth a lot more in the long run if you keep the loan for more than a couple of years. A low start rate may be worth the trade-off if it lasts for more than three months. Many negative amortization loans have a start rate that is only good for one month after which the interest rate becomes fully indexed. This means that your interest rate could go from 2.75% to, say, 6.50% after just one month. Compare that to a start rate of 5.25% on a loan that adjusts annually. The start rate is higher, but it lasts for twelve months, not just one.

On the positive side, low start rates are great if you are only going to own the property or have the loan for a relatively short time. Also, life caps are often set relative to start rates, so that a low start rate may be tied to a lower life cap.

What about the life cap?

The importance of the life cap, the maximum interest rate your loan can have, is directly proportional to how long you will have the loan. If you are only going to be in your loan for three years or less, your focus should be on a low start rate and adjustment cap. However, if you think you might keep your loan for a longer period of time, your life cap can be very important.

Remember, although it happens very infrequently, there are times when interest rates have moved steadily higher for three to five years, or even longer. Remember your risk profile—how willing you are to take a chance that your loan may go to its life cap and stay there for a while? Also, most borrowers tend not to keep an arm in periods of stable or declining interest rates. When interest rates periodically dip, many who plan to remain in their property for a considerable length of time refinance into fixed rate mortgages.

What about negative amortization or 'neg-am' loans?

Amortization is the gradual decrease of the principal balance of your loan over time. Negative amortization reverses the process—**your principal balance gradually increases because your monthly payment is smaller than the mortgage interest you owe each month.** The principal balance of your mortgage is the amount you borrow, your loan amount. The cost of borrowing that money is the monthly mortgage interest you pay.

- **With a traditional amortizing mortgage:** you pay back all the interest owed each month and some of the principal; your principal balance gradually decreases.
- **With an interest-only loan:** you pay all of the interest owed each month and none of the principal; your principal balance doesn't increase or decrease (however, you always have the option to pay principal if you choose).
- **With a negative amortization loan:** you're able to pay less than the interest owed each month, and none of the principal. The difference between the interest owed that month and what you paid is added to your principal balance. Your principal balance gets larger each month.

There are **two types** of negative amortization loans. **Option ARMs** have an interest rate that adjusts every month, and a low minimum payment that changes annually. This minimum payment increases only slightly each year no matter how high the interest rate is on the loan. **Hybrid Neg-am** loans have a relatively high interest rate that is fixed for five or seven years, but a low payment that is also fixed for either five or seven years. This fixed payment is based on an interest rate several points lower than the loan's interest rate.

Neg-am loan disadvantages

- **Difficulty selling:** In a housing market with little or no appreciation, if you have eaten into your equity with neg-am, you may not have enough left to make an upward, or even a lateral, housing move in the future.
- **Hard to refinance:** Even if interest rates drop, you may not have enough equity left to refinance into a fixed-rate loan.
- **Loss of control:** There is a limit to the buildup of negative amortization. Once your loan balance has increased to 110% or 115% of its original size (depending on the lender), you could lose the minimum payment option and see your payment more than double in a single month.
- **Penalties:** The loan's prepayment penalty may make it prohibitively expensive to refinance.

Neg-am loan advantages

- **More affordable:** Negative amortization can be viewed as a mini home equity line that you draw on each month to help make your mortgage payment more affordable.
- **Flexible:** Having a smaller payment can be important if there's a need to reduce your monthly cash outflow, in case of a job loss, for example.
- **Cash bridge:** You may have a pending liquidity event—an inheritance, an IPO, a bonus—and need the lower neg-am payment until it occurs.

- **Cash flow:** You may like having extra money each month for unforeseen expenses. Also, negative amortization is always optional.

When shopping for a “neg-am” loan, buyer beware. There are many conflicting opinions about which loan is the best, and lenders are always adding attention-seeking bells and whistles—1.25% rate!! 5-year fixed at 4.25%!! Remember, if it looks too good to be true, it probably is.

Much like the car industry, lenders create a product, price it for profit, then market it aggressively—adding enticing marketing hooks: a very low starting interest rate (for one month), a payment fixed for five years at a low rate (with the loan balance increasing by 15% over the five years), no points (but with a large prepayment penalty).

What is an Option ARM?

Option ARMs have an initial ‘teaser’ interest rate, usually good for one month, setting a low initial payment. This is your minimum required payment. Option ARMs have an annual cap on the minimum payment—**not on the interest rate**—that allows the payment to increase by only 7.50% per year. For example, a payment of \$1,000 in year one would increase to \$1,075 in year two. However, after the first month—not year—the interest rate on the loan adjusts upward dramatically, generating a new, sharply higher payment. You have the option of continuing to make the initial, lower payment. The difference between that initial teaser payment and the new interest-only payment based on the higher rate is added to your principal balance. Your principal balance gets bigger every month; how much bigger depends on how high your interest rate is at each monthly adjustment.

Option ARM example

Let’s use as an example a monthly adjustable neg-am loan with start rate of 1.00%, and a margin of 2.35% over the 12-Month Treasury Average (MTA) on a loan balance of \$500,000. The base payment at the start rate

of 1.00% would be \$2299. This rate and base payment are both good for one month. At the end of the first month the loan will be fully indexed; let's say that at the beginning of month 2 the index is at 4.827% (where it is in November of 2006) so in month 2, the new rate would be 7.187% [4.827% (index) + 2.35% (margin) = 7.187% (fully indexed rate)], and the new interest-only payment would be \$2994; with interest and principal the payment would be \$3390.

At this point you have three options: pay the new interest-only payment, \$695 more than the minimum, or pay principal and interest, \$1091 more than the minimum. Or, you can continue the original payment of \$2299, and have the difference between that payment and the interest only payment, \$695, added to your principal balance. This continues, with monthly adjustments in your interest rate and payment to reflect any change in the index, until the end of the first year. Then, because of the payment cap, the original base payment (not the interest rate) increases by only 7.50%, or from \$2299 to \$2471. Meanwhile, each month your payment is refigured based on that month's index plus your margin. Remember—each month you make that minimum payment your loan balance is increasing, and your new payment each month is figured on that new, higher, balance. If the loan went to its life cap, the interest-only payment would be over \$4000 each month—a lot more than the \$2299 that you signed up for.

What is a hybrid neg-am loan?

Also called fixed-pay ARMs, hybrid 5-year or 7-year fixed neg-am loans have a payment based on an interest rate that is 3.00% or more lower than the loan rate. If the loan rate is 7.25%, your payment will be based on a rate of 4.25% or lower. Guess which rate the lenders advertise when they are trying to sell you on the loan? The negative amortization will be at least 3% of the loan balance each year; this means that on a \$500,000 loan your principal balance would increase by at least \$15,000 per year. See the detailed example below to compare doing a negatively amortizing 5-year fixed to one that has an interest-only payment.

Hybrid neg-am example

We'll use a 5-year fixed neg-am loan of \$500,000 with a payment based on 4.25%—that would be \$1,770—and an interest rate fixed at 7.25%, which would have an interest-only payment of \$3,020. So, if you make the minimum payment of \$1,770, you would be adding \$1,250 per month to your loan balance ($\$3,020 - \$1,770$), or \$15,000 per year, or \$75,000 over the five years of the loan. Again, at the end of five years you would owe \$575,000. The other necessary piece for this example is the interest rate on a 5-year fixed interest-only loan that has no negative amortization, which is going to be about 1.00% lower in interest rate—for this example 6.25%, which would have a payment of \$2,604. If you got the 5-year fixed with no negative amortization at 6.25% and made the \$2,604 payment your total of payments over the five years would be \$50,000 more than if you had made the \$1,770 payment ($\$2,604 - \$1,770 \times 60$ months), but your loan balance would be \$500,000, not \$575,000. **Even though the neg-am payment was \$834 lower than the payment on the fixed, at the end of five years the neg-am loan would have cost you \$25,000 more.**

What is an alternative to a neg-am loan?

One way to get the advantages of neg-am is to have an interest-only mortgage with the rate fixed for at least seven years, combined with a home equity line that you draw down slightly each month to help pay your mortgage payment, making it more affordable. Although your principal balance is still increasing, this gives you the cash-flow benefit of a neg-am, while giving you a low fixed interest rate for your first mortgage.

What about stated-income, stated-income/stated-asset, or no-doc loans?

These loans are for people who either would not qualify using lender income or asset guidelines, or who want to avoid providing extensive income or asset documentation.

Stated-Income	Lender checks credit, verifies seasoned assets and two year employment history and appraises property
Stated-Income/Stated-Asset	Lender checks credit, verifies two year employment history and appraises property
No-Doc	Lender checks credit and appraises property

Stated-Income (also known as an ‘easy doc’ or ‘quick qualifier’):

The lender does not verify the gross monthly income you put on the loan application. You do not have to provide tax returns, W-2s, or pay stubs. However, the lender will verify a two year employment history, whether you are salaried or self-employed, and will verify your assets and that they are seasoned – have been in your account for sixty days.

Stated-Income/Stated-Asset: The lender does not verify your income or ask for copies of your account statements to verify the funds you listed on your loan application. However, the lender will want to verify employment.

No Doc: The lender does not ask for any information on your income, assets, or employment. These sections of the application are left completely blank. The lender will get your credit report, and an appraisal and preliminary title report—nothing more.

Stated-income loans are often used by people who don’t have a two year income history. For example, if your business has been steadily growing and your income is rapidly increasing you may want to state your income so that you can qualify using your current income, not a two year average. These loans are also used by self-employed people whose reported income appears low because of certain deductions.

A stated-asset loan may be useful when the funds needed to close on a purchase cannot be verified. You may want to state your assets because you have a large, recent deposit and underwriting guidelines require that those funds have been in your account for at least sixty days. The funds may be coming from overseas, from an unrelated third party, or from under your mattress.

Generally, **no-doc loans require a relatively low loan-to-value**, or they become very expensive. No-doc loans are useful for people who are retired, temporarily unemployed, or who don't have a verifiable two-year history of self-employment.

One advantage of these loans is simplicity and less paperwork. If your financial situation is very complicated—partnerships or multiple businesses, for example—these loans can be approved more quickly and with less bother than a full documentation loan. You may also appreciate the privacy that stated income provides. I have had partners in law firms and hedge funds whose partnership confidentiality provisions prevented them from providing the partnership tax returns that a lender wanted to review.

The primary disadvantage is that these loans may require a larger down payment if you are purchasing, or more equity in your home if you are refinancing. Also, the terms of these loans—the interest rate, fees, or conditions—are often not as favorable as those attached to a full documentation loan.

An important note: Lenders are becoming more careful with stated-income loans. With these loans you must be stating your income – not what you would like your income to be, or what your lender has told you is needed to qualify for the loan that you want.

Why choose an interest-only mortgage?

With an interest-only mortgage you pay mortgage interest, and no principal, for a specified period of time. **Your mortgage balance remains the same; it does not increase, or decrease.**

Interest-only mortgages can push an emotional button for those who are financially conservative. Before the advent of IRA's and 401(k)s the home mortgage was often the only savings plan that people had, and could afford, and most Americans stayed in their home until their mortgage was paid off. **Today, with a multitude of savings options and a very mobile society, the decision whether to pay principal on your mortgage should be made based on your long-term financial plan.** Paying principal on your mortgage will give you an after-tax return on the principal payment slightly lower than the mortgage interest rate.

Advantages of an interest-only loan:

- Lower minimum payment
- Flexibility—pay principal if you choose
- Affordability—you can qualify for a larger loan

Disadvantages of an interest-only loan:

- Loan balance does not decrease over time
- Payment may rise sharply after the interest-only period
- You don't have the 'forced savings' of a principal & interest mortgage

Paying interest-only is always optional: during the interest-only period you can pay principal if you choose. If you do pay principal, your loan will amortize as it would if it were not interest-only.

Let's say your interest only payment is \$2500 per month, and would be \$3000 a month if you had a 30-year fixed loan and were paying principal and interest. If you pay \$3000 a month on the interest-only loan your loan amortizes—the principal balance decreases—just as if it was a regular, fully amortizing, loan.

If you choose the interest-only option with a 30-year fixed or a 15-year fixed, you will have to begin paying both interest and principal after either ten or fifteen years, depending on the lender. This will mean a much higher payment.

A \$500,000 loan with a 6.00% interest rate would have an optional interest-only payment of \$2500 per month for the first ten years. If you paid no principal during those first ten years, beginning in year eleven your payment would increase to \$3582 per month. Although this is a big jump—over \$1100—it represents an increase of only 3.66% per year, compounded, over the initial \$2500 a month payment, roughly in line with the current inflationary trend.

What about a prepayment penalty?

A prepayment penalty is a fee that you will pay your lender if you pay off your loan within a specified time frame. The time frame can be as short as five months or as long as five years from the date you obtain the loan. The penalty can range from 1.00% of your loan balance up to 5.00%. Some penalties are flat—2% of the loan balance for the first three years; others decline over time—5% in year one, 4% in year two, 3% in year three, and so on.

- **The penalty is generally assessed on only 80% of what you owe.**
- **Some lenders offer a ‘soft’ prepay**—you have no penalty if your house sells, only if you refinance.
- **With a ‘hard’ prepay you have to pay the penalty if your loan pays off for any reason.**
- **Generally, lenders will not waive the prepayment penalty for a refinance**, even if you are going back to the same lender for the refi. If you are offered a loan with a prepayment penalty, it is very important that you understand the terms of the agreement and its implications.

Why would you consider a loan with a prepayment penalty?

These loans are popular because they generally have some combination of lower fees and interest rate than a loan with no penalty. You may want to consider a loan with a prepayment penalty if you are reasonably certain you will not be selling your property during the term of the prepayment penalty. However, if interest rates drop and you want

to refinance into a better loan, refinancing will probably be prohibitively expensive when you have to pay the penalty. This could cause you to miss an opportunity to have a lower interest rate for the life of your loan.

Murphy's Law is often operative with prepayment penalties—especially for those who are absolutely certain that they will not be selling their home or refinancing. A sudden relocation, a once-in-a-lifetime deal on another house, unexpected medical expenses, a death or divorce: these are all circumstances that can mandate the sale of your house or a refinance and trigger the penalty.

What is a rate lock?

When you lock your interest rate, the lender guarantees that the rate will not change if your loan closes by the lock date. The lender is assuring you that your rate will not go up if you close before the lock expires, even if rates have risen. You are also agreeing to that rate even if interest rates drop. You are trading no pain for no gain. However, as outlined below, most lenders have a policy that will let you take advantage of a very sharp rate drop after you have locked in.

- Loans are generally locked for 15, 30, 45, or 60 days. **The pricing of the loan increases slightly as the lock time increases**; all things being equal, it is better to lock for 15 days than for 30, for 30 days rather than for 45.
- **The minimum term of the lock is dictated by close of escrow if it is a purchase loan, or the amount of time your lender thinks necessary to close a refinance loan.** If your purchase is closing in three weeks, you can't get a 15 day rate lock because you're not closing for 21 days. In a booming refinance market you may have to do a 45 day lock because overwhelmed lenders can't close your refinance loan sooner.
- When you lock in your rate **ask what the lender's policy is for an extension** if you miss your lock date. Most lenders will allow an extension for a small fee.

When should I lock in my rate?

It is impossible to know what interest rates are going to do in any 15 to 60 day period. **Interest rates are inherently volatile, and they can move sharply on unexpected economic news or world events.** The release of the monthly unemployment number or the monthly consumer price index can have a dramatic effect; so can the tone of a Federal Reserve Board governor's after-dinner speech in Oklahoma City. Because of this uncertainty, most lenders will want you to lock in your rate upon receiving your application.

If you wait to lock in, expecting to get a better rate, your chances are better if the current rate trend is down. When rates have been rising over the past three to six months, hoping for a tick down in the next few weeks is a gamble. Even if rates have been steadily declining, in any given month they can still move higher. In fact, even hugely successful bond traders bet right on short-term interest rate moves only 55% to 60% of the time. It is unlikely that a mortgage broker, a banker, or you will do better. If you are satisfied with the rate and terms you have been offered, locking in the rate when you apply is a prudent move.

What happens if rates drop after I lock?

Most lenders have a 'float-down' policy. This policy defines the circumstances under which a lender will lower the rate on your loan if rates have dropped after you have locked and before your loan documents have been sent to escrow for signing. This policy varies from lender to lender—you should ask about it when you lock in your rate. **For lenders who have a float-down policy, the rates have to drop substantially before they will drop your rate.** As a rule, if rates have dropped one-quarter of a point, your rate will float down by one-eighth of a point. If rates have dropped, you have time, you are working with a mortgage broker, and you aren't happy with the float-down policy, the broker may be able to submit your loan to a different lender.

It is almost impossible to hit the bottom in rates when buying or refinancing. If you are doing a loan that has no points and no prepayment penalty—something I recommend—you can always refinance down the road if rates continue to drop. Remember, by locking your loan, the lender is providing an important service. Lenders are at risk when you have locked a rate—lenders hedge their exposure and lose money when borrowers who lock an interest rate fail to close.

What are interest rates going to do in the future?

When asked what interest rates are going to do, my answer is always the same: they will go up and down. I am not being flippanant in my response. Interest rates went up from the early 1930s until 1981. During most of that time—over forty years—they went up in a predictable, gradual fashion, going up two or three points, then down one or two points every several years. Only at the end of the cycle, in the late 1970s, did they spike, and this is what everyone remembers. Since the inflation-induced highs of the late 1970s, they have been coming down the same way they went up—down two or three points, up one or two points over several years.

If you had an adjustable rate mortgage during the last 25 years, you did very well: your monthly payment moved steadily lower as interest rates fell. Now some pundits say that the long-term trend is turning around, and, remembering the late seventies, we are looking at years of high interest rates.

Even if the long-term trend has changed, **it is very unlikely that rates will shoot up immediately and dramatically,** and stay high for a long period of time. The common interest rate cycle is a rise of two or three points over a period of a few years; this slows the economy and, as the economy slows, interest rates begin to fall. Over a few years the falling rates stimulate the economy. As the economy strengthens, rates begin to rise and the cycle repeats.

The most prudent strategy

Long-term historical trends show that even if we are again entering a long-term era of rising interest rates, then the up two or three points, down one or two points over a period of four to seven years is the norm. **The most prudent strategy is probably neither the most conservative**—a fixed rate—**nor the most risky**—an ARM—but the choice in the middle—a hybrid fixed for 5, 7, or 10 years. The best strategy for choosing the right loan is discussed in the chapter, “**Which is the best loan for me?**” on page 17.

What about a home equity line of credit, or a home equity loan?

You can tap the equity in your home by using a home equity line of credit (HELOC) or a home equity loan (HELOAN). These loans generally require less paperwork and time than a refinance of your primary mortgage, and have little or no closing costs. HELOC/HELOANS are also frequently used in combination with a first mortgage when a borrower is purchasing a home and putting down less than 20%.

Both HELOCs and HELOANS are priced primarily using the borrower's credit score and the property's loan-to-value. Getting a credit approval for one of these loans for an amount up to \$1,000,000—subject to an appraisal and verification of information in the application—will generally take less than 24 hours.

What is the difference between a HELOC and a HELOAN?

- The HELOAN has a fixed interest rate and fully amortizing payments that include principal and interest; the HELOC has an interest-only payment option and is keyed to the prime rate and always adjusts monthly whenever the prime rate moves, with one exception that will be addressed below.

- The full amount of the HELOAN must be taken at close of escrow; with the HELOC, you have the option of using as much, or as little, of the available credit as you choose.
- With the HELOC you have a great deal of flexibility. If you pay down a portion of the HELOC your payment will drop proportionately. If you choose to run the line back up later you may. Paying down a portion of the HELOAN will not change the payment, and once a portion has been paid down, you can not run the balance back up again like you can with a HELOC.
- The fixed interest rate on the HELOAN will usually be .25% to 1.00% lower than the adjustable interest rate on the HELOC. However, the interest-only payment on the HELOC will be lower than the fully amortizing payment on the HELOAN, even though the HELOC interest rate is higher.
- The most recent innovation in real estate finance is a HELOC that allows for a fixed interest rate for a portion of the line amount that has been used, while the unused balance of the credit line will have an adjustable rate when you use it in the future.

When is a HELOC a better choice?

- **If you want a resource you can tap at any time:** this is important because you only pay for the money you are using. The interest only option keeps the payments low.
- **If you want flexibility:** you can pay the HELOC down in chunks, all the way to zero, and lower the payment proportionately, and then run the line back up again if you have a use for the money.
- **If you are less concerned about having an adjustable rate and a changing payment.**
- **If you are able to pay your credit line down in large chunks—** through bonuses, a refinance after doing extensive remodeling, the sale of a piece of property, or a liquidity event.

There is a new product in the marketplace, a HELOC that allows you to lock in at any time a fixed interest rate for all or part of the amount of the HELOC that you have used. If you are getting a HELOC, ask if you can have the option of fixing the interest rate for a portion of the line amount in the future. This can be a very valuable option if interest rates begin to rise, and combines the best features of both the HELOC and the HELOAN.

When is a HELOAN a better choice?

- **If you are more financially conservative** and want a predictable monthly payment and a fixed interest rate, and you can afford the higher monthly payment.
- **If you need a particular sum of money at one time**, and are fairly certain that you will need to pay it back gradually over a long period of time.

Is the interest on a HELOC or HELOAN tax deductible?

The interest on second mortgages, when used for a primary residence or second home, may be tax deductible, subject to the standard IRS limits on the deductibility of home mortgage interest.

Whenever you have tax questions related to real estate finance, we recommend that you speak to a CPA or financial advisor who is familiar with your particular situation and state and federal tax law.

How can a HELOC or HELOAN be used in a purchase transaction?

When you are purchasing a home and putting down less than 20%, and you are getting a non-conforming (jumbo) loan, most lenders will require that you have a HELOC or a HELOAN for any amount financed in

excess of 80% of the purchase price. For conforming loans the lenders will make loans in excess of 80% of the purchase price but will require mortgage insurance; a HELOC or HELOAN for the amount over 80% loan-to-value eliminates the need for that insurance, and the interest on the HELOC or HELOAN is usually tax-deductible, while the mortgage insurance is not, unless your income is less than \$100,000 a year.

What do I need to know about appraisals?

An appraisal is done for a lender by a state-licensed appraiser. **In a purchase, the purpose of the appraisal is to justify to the lender that the price being paid for the house is reasonable based on recent comparable sales (comps) of similar properties in the same area.** It is unusual for a purchase appraisal to come in below or above the purchase price.

In a refinance, the appraiser doesn't have a sales price to use as a baseline, and usually starts using your estimated property value as an initial guide. The appraiser then uses sales of comparable homes that have closed within the last six months, and currently listed comparable homes, to determine a final value.

An appraisal is not necessarily an accurate guide to the market value of a home. Despite the efforts of lenders and state and federal regulators to standardize appraisals, there is still a lot of subjectivity and flexibility in the appraised value.

Two important factors to consider:

- In an affluent market like northern California, with many unique homes, the comparables that the appraiser chooses, and how the appraiser adjusts their value to bring them into line with the property being appraised, can have a big impact on the end result.

- In choosing comparables, the appraiser is required to use homes that are close geographically, and have similar square footage and room counts. This tends to minimize important features that determine property value. Amenities such as a spectacular view, great floor plan, first class home theater, may not be given their real value. Conversely, negatives—a bad floor plan, a hillside home that gets little light, etc.—are hard to quantify, and a 'problem' house may appraise for more than it would sell for in the marketplace.

If you feel that your property has been appraised for less than it is worth, and that is affecting your ability to get a loan, you may be able to work with your lender to have the value raised. You must identify other comparables that the appraiser can use to justify a higher value. If that doesn't work, and you are working with a mortgage broker, ask if there another appraiser who might see things differently. Sometimes the only way to get the appraisal you believe is fair is to find a new appraiser by switching lenders—but this doesn't always work.

In a situation where the appraised value is very important—a divorce, probate, or some other financial settlement—you may not want to rely on an appraisal obtained by another party. **Remember, appraisals always have a degree of subjectivity, and if you want to be sure you are being treated fairly, get your own appraisal done.**

Although a licensed appraiser can be found online, it is better to get a referral from a real estate agent or lender. If you contact us, we can refer you to an appraiser we have experience with who works in your area. To check the qualifications of an appraiser you are working with, you can visit the website of the California Office of Real Estate Appraisers at: www.orea.ca.gov/html/lic_appraisers.asp.

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What does a buyer need to know?

Find the right lender

The first step in the purchase process is to identify the right person to work with. Read “**How do I find a good lender?**” on page 7. Find someone who is experienced and can meet timelines to help you avoid last minute surprises and delays. You don’t want to go into a closing and find that the interest rate, the type of loan, or the loan terms are different than what you had expected.

Ask relevant questions

During the pre-approval process you should be asking a lot of questions. Having the completed Buyer’s Worksheet on page 53 will make it easier for your lender to give you good feedback and advice. Reading *The Insider’s Guide to Mortgages* will help you understand the many different loan types and terms. You will want to review the multiple options you have in structuring your purchase. For example, if you currently own a home you may need advice on how to buy your new home before your old one is sold. If you are planning to spend money to remodel your new home, you may want to find a loan that requires a minimal down payment. If you are buying investment property you may be looking at a ‘reverse exchange’ and will need to understand how to make that happen so you don’t lose the tax benefits of the exchange.

Get pre-approved

When buying real estate you need to be pre-approved for the mortgage. The pre-approval will define the limits of your purchase, and the pre-approval letter from your lender will put you in a stronger position when you negotiate your purchase price. “**How do I get pre-approved?**” and “**What purchase price will I qualify for?**” on page 47 will explain the process.

What are the tax benefits of home ownership?

There are three primary tax benefits from home ownership:

- Deductibility of the mortgage interest and property taxes
- Deductibility of certain closing costs when you purchase a home
- Profit made from the sale of a residence is tax free up to a certain limit

How does the mortgage deduction affect my monthly housing expense?

You can, within IRS rules, deduct your home mortgage interest and your property taxes from your taxable income. Most CPAs will advise that you can deduct the mortgage interest paid on a maximum of \$1.1 million dollars in combined mortgage debt on your primary residence and second home; check with your CPA or tax preparer to confirm that this applies to you. In California, if you are in a high tax bracket, the savings can be substantial.

Understanding the tax benefits of purchasing is essential in determining how much it will really cost you to live in your new home. When you are renting, figuring your monthly housing cost is easy—it's the rent. Many people decide what they can afford to pay when purchasing their first home based on their current rent. If you are paying \$2500 in rent, and putting \$1000 away in savings each month, then you will logically assume that you can afford to pay \$3500 a month when you buy a home. However, when you own a home the formula is a little more complicated—you have to factor in the tax savings.

For a homeowner, monthly housing expense may have four components:

- Mortgage principal—unless you are using an interest-only loan
- Mortgage interest, including the interest on any equity line or second mortgage

- Property tax, which in California is paid twice a year, in December and April. However, when budgeting it is best to look at it as a monthly expense. Monthly property tax can be estimated by taking the purchase price, multiplying by 1.25%, and dividing by 12.
- Homeowner's insurance. For a rough estimate, \$100 per month for homes under \$600,000, \$150 per mo. for homes between \$600k and \$1.2 million, and \$200 per mo. for homes over \$1.2 million.

When you add these numbers together, you get your pre-tax monthly housing expense. This number does not factor in the tax savings. Mortgage interest and property tax are deductible. When you own a home you pay income tax on the amount of your income after your deductions for mortgage interest and property tax, subject to other IRS rules. In most circumstances, when you own your home you pay less in state and federal income tax than you do when you are renting. Determining that tax savings on a monthly basis and subtracting it from your pre-tax monthly housing expense will let you figure what it costs you to own your home after taxes. This is the **rental equivalent** of your monthly housing expense.

To accurately figure your tax savings, you should speak with a CPA, tax preparer, or financial advisor about issues such as the alternative minimum tax, other deductions you are taking, or how tax law changes may affect the amount of your deduction for mortgage interest and property taxes. To help you, your tax person will need the approximate annual mortgage interest and property tax you will be paying based on the price range you are looking in and on current interest rates; we can help you determine that number.

What other tax savings are available to homeowners?

When you purchase your home, most of the closing costs are not tax deductible, with one exception—**loan discount points or origination fees. These are tax deductible regardless of who pays them.** That means that if the seller pays your closing costs you can still deduct any points paid to the lender to buy down the interest rate on the loan.

When you sell your home you can make a profit of up to \$500,000 when you sell, and pay no income or capital gains taxes if you have owned and occupied it for at least two of the past five years (assuming you are married—for a single person the deduction is \$250,000). You don't have to reinvest the proceeds.

Why is being pre-approved so important?

If you are seriously considering purchasing a new home, you'll want to get pre-approved. When you are pre-approved, a lender has made a firm commitment to provide mortgage financing for your home purchase. **In a competitive real estate market, a strong pre-approval letter can make the difference in having your offer accepted over competing offers, even ones at a higher price.** If you are pre-approved, the purchase process is much smoother, and you will be much more comfortable meeting the necessary timelines.

The pre-approval process determines the maximum purchase price you can afford based upon your down payment, your financial qualifications, and the underwriting guidelines for the loan program you have chosen. **You may qualify for a purchase price that gives you a monthly payment that is more than you feel that you can comfortably afford.** Decide on a payment you are comfortable with, including property taxes and homeowner's insurance and/or association dues, and factoring in the tax advantages of buying. Then work with your lender to determine what size mortgage—and what price home—you qualify for.

The pre-approval process is very important. **The price of the home you can afford, the size of the mortgage for which you can qualify, and the amount of the down payment you will need may vary dramatically depending not only on interest rates, but also on the loan program and lender you choose.** It is critical to do your homework, ask a lot of questions, and understand your options. You may be able to buy a more expensive house than you thought possible, but you don't want the trade-off to be a mortgage that leaves you financially strapped, or with less equity than you started with.

How do I get pre-approved?

The pre-approval process begins with taking the steps outlined in “**How do I shop for a mortgage?**” on page 7 and “**Which is the best loan for me?**” on page 17. You need to find the right lender and understand which loan program best meets your financial needs and goals. Once you have identified your lender, read “**What does a lender need to qualify me and provide an accurate rate quote?**” on page 10 and fill out the Buyer’s Worksheet on page 53. This is the information a lender needs to pre-approve you, and to work with you on finding the best loan for your situation.

What purchase price will I qualify for?

The lender uses the pre-approval process to determine the maximum monthly mortgage payment for which you qualify. Your lender then takes that payment amount, the interest rate for the loan you have chosen, and your down payment, and determines your maximum purchase price.

Again, it is very important to remember that you may qualify for a mortgage payment that is much higher than you feel that you can comfortably afford. Or, you may qualify using a loan program—negative amortization, for example—that has features that you don’t like. This is why understanding the process is so important.

Your qualifying payment is derived from the debt-to-income ratio allowed on the loan program you have chosen. If the lender will not permit a debt-to-income ratio higher than 38%, then the monthly payments on your housing debt, revolving debt, and installment debt could not exceed 38% of your gross (pre-tax) monthly income. **What makes the pre-approval process seem confusing is that the allowable debt-to-income ratio can vary dramatically between lenders and loan programs.** You may find that you can qualify for a far bigger mortgage from one lender than from another; or that the information from a lender is very different than that from an online mortgage calculator.

A borrower who has good credit, can document their income, and is putting down 20% or more may be allowed a debt-to-income ratio of over 50%. Lenders will sometimes make exceptions for compensating factors such as substantial liquid reserves and/or excellent credit.

What about down payment?

Putting down 20% of the purchase price is the standard for the purchase of a home. However, **many people, especially first-time homebuyers, put 5% or 10% down—or sometimes nothing at all—with a ‘piggyback loan’** a combination of an 80% loan-to-value first mortgage and either a home equity line or a home equity loan.

During the pre-approval process your broker or loan officer will discuss your down payment options. The minimum down payment will depend on the lender's guidelines, the loan size and type, your credit score, and whether you are doing a stated income loan.

Often lenders will make an exception to their down payment requirements for a ‘strong’ borrower, one with some combination of high credit scores, high and/or stable income, and asset reserves. For example, a lender might look favorably on a very small down payment from a borrower with a sizable 401k; the borrower might not want to liquidate retirement funds to use for the down payment, but could liquidate those funds in the future if the situation demanded it.

Figuring out your down payment

When figuring what you have available for down payment, make a list of:

- All of your liquid assets, cash and savings
- Stocks and bonds
- Net proceeds from sale of current residence
- IRA, Keogh, 401k, or other retirement savings

Next, decide how much of these assets you want to use for your purchase. Add to this any gift money you will be receiving. You can use the Buyer's Worksheet on page 48 to aggregate your information.

Unless you are doing a stated asset loan, you will need account statements, or a verification of deposit that your broker or loan officer will obtain, to show the lender that your down payment money is 'seasoned'—that you have had that money in your account(s) for at least two months. The lender wants to be sure that you haven't secretly borrowed the money for your home purchase, which would add to your monthly debt and increase the lender's risk.

If you are receiving gift funds, you will usually need a letter from your benefactor—most lenders require that it be a relative—stating that the money is a gift and there is no expectation of repayment. Some lenders may also ask for the most recent statement from the account the gift is coming in order to confirm that the money is being sent by the donor. For more information on gift funds see **"What about using gift funds?"** on page 51 and **"What about the tax issues around gift funds?"** on page 52.

What about reserves?

Most lenders will want you to have some money left in reserve after the purchase.

Depending on the lender and the loan program, reserve requirements are based on one of three criteria:

- **Your total monthly housing expense** (mortgage, taxes, and insurance)
- **Your total monthly debt**—total monthly housing expense combined with your total monthly consumer debt (credit card bills, car payment, installment loans, student loans, etc.)
- **Your total monthly income** as stated on your loan application

Whichever of the three criteria the lender is using, **you will be required to have a certain number of months of that amount in reserve.**

Lenders will only count 70% of the value of your retirement assets toward reserves. You may be able to use gift funds to meet the lender reserve requirement.

Reserve requirements can vary greatly from lender to lender. Underwriting standards and requirements often resemble a bell curve. With reserves, that means that on the lenient side there are a few lenders who will require no reserves at all, and on the strict side there are a few who require 12 months of income in reserve. Most lenders are in the middle, and will want you to have two to six months of your total monthly housing expense in reserve after close of escrow. **A good mortgage broker can find you a loan program that is flexible on the amount of reserves you will need.**

Consider your closing costs

Your reserves are the liquid assets that you have left after your down payment and closing costs. In figuring your reserves, it is important to have your lender give you a detailed estimate of your closing costs early in the transaction.

You may be able to finance a substantial portion of your closing costs by negotiating to have the seller give you a credit for nonrecurring closing costs (loan fees, lender and broker fees, title insurance and escrow fees; generally these are about 70% of total closing costs), in lieu of a price reduction.

For example, you may have had an offer accepted at \$693,000 for a home listed for \$700,000. With a 10% down payment of \$69,300 and total closing costs of \$10,000, you would have to come up with about \$80,000 to close. If, however, you paid \$700,000 for the house and got the seller to credit you \$7,000 for the nonrecurring closing costs, you would only need about \$73,000 to close. Your mortgage would be about \$7,000 higher—you are basically financing your closing costs—but you would not have used up as much of your cash.

What about using gift funds?

Using gift money to help with the purchase of a residence is very common. High home prices have made it difficult for many young borrowers to get a foothold in the housing market without some assistance. **If you are going to talk with someone close to you about receiving a gift, there are some things you and your donor need to know.**

Many competitive jumbo loan programs, ones where the loan amount is greater than \$417,000, require you to have liquid assets equal to 5% of the purchase price seasoned in your account in addition to the gift funds you will receive from your donor, unless you are putting 20% or more down. Seasoned funds are those that have been in your account for 60 days or longer. If you have less than 5% of your own funds seasoned, depositing enough gift money to make up the difference may enable you to get a lower interest rate—so long as you can deposit that money 60 days before you enter into a purchase contract. Remember, this is only important if you are receiving gift funds, you have less than 5% of your own funds seasoned in your account, and your total down payment is less than 20%.

Different lenders have different requirements for gift funds. Some lenders require a letter from the donor stating that the funds are a gift, and that there is no expectation of repayment. A lender may also want to see a copy of the donor's check or proof of a wire transfer from the donor, and a statement from the account the money came from showing that the donor had the funds available to make sure that you aren't 'washing' a hidden loan you have received from someone else through a donor's account. The hassle and privacy issues entailed can sometimes be avoided if the donor deposits the funds directly into your escrow account, and the escrow officer can then list the funds and the donor's name on the closing statement.

Always remember that there can be many exceptions in loan underwriting. A mortgage broker with multiple loan sources—including lenders with more flexible underwriting requirements—may be helpful in making this process smoother.

What about the tax issues around gift funds?

Note: *what follows is a summary of gift tax rules; always talk to your own CPA or financial advisor before gifting money.*

If you are going to be receiving gift money from a family member to help with your purchase there are two considerations—the maximum amount that a donor can give without triggering tax consequences, and the tax consequences if that amount is exceeded. The mission of *The Insider's Guide to Mortgages* is to be concise and clear; but because we are about to talk about IRS regulations that will not be possible.

Any person may make a tax-free gift of \$11,000 annually to multiple recipients. For example, two parents can each give \$11,000 to one child for a total of \$22,000, and they can give \$44,000 to a couple. So if Alex and Chris are buying a home together, and Chris's parents want to help, Chris's mom can give \$11,000 to Alex, and \$11,000 to Chris; Chris's dad can do the same—totaling \$44,000. This should be done in four separate checks.

Because the \$11,000 limit is for the calendar year, a donor can gift \$11,000 in the last week of December, and another \$11,000 in the first week of January. Some donors do a combination of a gift and a loan, and each year forgive a portion of the loan up to the maximum amount of gift allowed.

If the \$11,000 annual limit to an individual is exceeded, the donor—not the recipient—must file a Gift Tax Return, IRS Form 709. There is no immediate tax owed when the \$11,000 limit is exceeded with one exception. Every person is allowed a lifetime tax exemption of \$1 million for gifts that exceed the \$11,000 per person annual limit. When the \$1 million lifetime limit has been met, there is an immediate tax cost for additional gifts. If the donor hasn't hit the \$1 million dollar mark in total gifts, but has exceeded the \$11,000 annual limit to an individual, there is no immediate tax owed, but the donor's estate may have a higher tax bill. Any inheritance tax will be based on the value of the estate less a \$1 million exclusion. If the deceased has exceeded the gifting limit, the \$1 million dollar exclusion declines by the amount that the gift limit has been exceeded during the lifetime of the deceased. Flat tax, anyone?

CREDIT SCORES

Borrower: _____

Co-Borrower: _____

You will need a tri-merge mortgage credit report. We can provide one for you at no charge.

EMPLOYMENT

Work Status (check all that apply): B = Borrower, C = Co-Borrower

- | | | | | |
|--------------------------|--------------------------|-------------------------------|-------------------------------------|--------------------------------------|
| B | C | | B | C |
| <input type="checkbox"/> | <input type="checkbox"/> | Employed receiving a W-2 | <input type="checkbox"/> | <input type="checkbox"/> |
| <input type="checkbox"/> | <input type="checkbox"/> | Partner, income on Schedule E | <input type="checkbox"/> | <input type="checkbox"/> |
| | | | <input type="checkbox"/> | <input type="checkbox"/> |
| | | | Self-employed, income on Schedule C | Investor: finance and/or real estate |

Do you own more than 25% of company?B _____ C _____

How long in primary line of work?B _____ C _____

How long with current employer?.....B _____ C _____

Any employment change, or significant change of income in the last two years? B _____ C _____

Current Monthly Income: B \$ _____ C \$ _____

Note: Using the same information, one lender may determine your income differently than another, especially if you are self-employed or had a recent job or income change. If you have questions, call us.

TYPE OF LOAN DESIRED

Type:

Loan Options:

- | | | | | |
|--|----------------------------------|-------------------------------------|---|--|
| <input type="checkbox"/> 30 year fixed | <input type="checkbox"/> 7/1 ARM | <input type="checkbox"/> ARM | <input type="checkbox"/> No points | <input type="checkbox"/> Interest only |
| <input type="checkbox"/> 15 year fixed | <input type="checkbox"/> 5/1 ARM | <input type="checkbox"/> Option ARM | <input type="checkbox"/> Points _____ | <input type="checkbox"/> Negative amortization |
| <input type="checkbox"/> 10/1 ARM | <input type="checkbox"/> 3/1 ARM | | <input type="checkbox"/> Prepayment penalty | |

PROPERTY

Purchase price \$ _____

Or price range you are considering \$ _____ - \$ _____

- | | | |
|---|---|---|
| Property type: <input type="checkbox"/> Single family | <input type="checkbox"/> Live-work loft | Property is: <input type="checkbox"/> Primary residence |
| <input type="checkbox"/> Low-rise condo | <input type="checkbox"/> Multi-unit, # of units _____ | <input type="checkbox"/> Second home |
| <input type="checkbox"/> High-rise condo | | <input type="checkbox"/> Investment property |

ASSETS

Funds available for down payment: \$ _____ (or) _____%

Assets:

Cash, money market, checking, savings, mutual funds, stocks and bonds \$ _____

Retirement, 401K, IRA, etc. \$ _____

Have the funds been in account for at least 60 days? _____

Home equity line of credit \$ _____

Gift \$ _____ Source _____

Other property owned: Current Residence Investment Second Home

Estimated value \$ _____ Total loans on other property \$ _____

What does an investor need to know?

Because an investment property is more expensive and more difficult to refinance than a residence, **most borrowers choose either a hybrid loan that has an interest rate fixed for at least seven years, or a fixed rate loan—unless they plan on selling the property in the first few years.** If the plan is for a 'quick flip', an ARM without a prepayment penalty may be the best choice; however, some 'quick flip' investors prefer a hybrid ARM with an interest rate fixed for three or five years in case they need to wait out a soft market.

Cash flow is an important consideration in an investment purchase. If you don't feel comfortable with negative cash flow, then a loan with the option of making an interest-only payment may be a good choice. That would allow you to make the interest-only payment in the early years, and, as rents rise over time, use any positive cash flow to pay down principal. When deciding on which type of mortgage, it is important to be conservative. You want to make sure that you can afford to keep the property if rents don't rise as fast as you planned, or if values don't increase as rapidly as you had hoped. For more information on choosing a loan see "**Which is the best loan for me?**" on page 17.

Although the same types of mortgages are available for investment properties, the interest rates, especially with a small down payment, are higher than those on mortgages for owner-occupied properties. These loans are also more likely to include a prepayment penalty. Qualifying for a loan on investment property may be more rigorous, with lenders wanting a lower debt-to-income ratio; remember that a lender will add to your income only 75% of the current or market rent from the property you are buying, less taxes and insurance, to determine your debt-to-income ratio. If you are stating your income the lender may require a higher credit score and more reserves for an investment property loan than one for a primary residence.

One of the first considerations when buying investment property is to **determine whether the property is classified as residential, or whether it is commercial or multi-family.** Residential properties

include condominiums, single family residences, and 2-to-4 unit properties. Some mixed-use properties may also qualify for residential financing—these are generally residential condominium projects which also have a small amount of commercial use, ground floor retail in a five-story condominium building, for example.

Commercial properties include retail, office, mixed-use where the use is primarily commercial, and a grab-bag of things from trailer parks to marinas, and require commercial loans. Loans for multi-family properties—those with more than four units—are classified as apartment loans. **The lenders, programs, interest rates, and qualifying standards are completely different for commercial and multi-family loans than they are for investor loans on single family residences, condos, and 2-4 unit properties.** These loans are best-handled by those who provide them on a regular basis, banks and commercial mortgage brokers, not by residential mortgage brokers or lenders.

What about a 1031 exchange?

1031 exchanges, as children of the tax code, have a long and complex web of rules and regulations. If you are involved in, or are contemplating, a 1031 exchange, you should consult with an exchange facilitator, a CPA, tax advisor, or legal counsel.

What do I need to know about a 1031 exchange?

IRS Code 1031 allows investors to defer paying federal and state capital gains tax and depreciation recapture when they sell an investment property and buy another investment property of like kind through an exchange transaction. This allows investors to move from property to property without having to pay tax on capital gains or depreciation recapture. **Used properly, a 1031 exchange can be a powerful wealth-building tool.** When you defer the tax, you have more money to invest in your next property. Effectively, the tax you are deferring is an interest-free loan from Uncle Sam.

What is a 'like kind' property, and what kinds of property cannot be part of a 1031 exchange?

In the class of real estate, 'like kind' simply means another investment property—you can exchange an office building for a farm, a single family residence for a trailer park or a condo. Generally, you can't exchange your residence or vacation home; however, it may be possible to use part of it. An example might be the sale of a farm; if the farmhouse itself was the primary residence, its value could be excluded from the exchange, but the value apportioned to the agricultural land and buildings could be exchanged. Another example is a duplex in which one unit was rented while the other was owner-occupied. Exchanges are limited to property in the U.S. and certain U.S. territories.

What is a reverse 1031 exchange, and how does it affect my financing?

In a 1031 exchange you sell one investment property to buy another; in a reverse exchange you buy before you sell. As with any 1031 exchange, to avoid paying capital gains tax, you must use all of the cash you are taking out of the property being sold as the down payment for the new purchase. What makes a reverse exchange difficult is that you aren't permitted to take out a bridge loan on the property you are selling, or to obtain additional financing on the property you are buying while waiting for the other property to sell. If you do, you risk losing all of the tax benefits of the exchange. Your options are to use your cash reserves or, if you don't have the cash, tap the equity in an unrelated investment property, or in your primary residence.

What do I need to know about TICs?

Note: *A TIC, or tenancy-in-common, transaction is complicated, and it is very important to understand the implications of buying an interest in a TIC before making an offer. The information presented here is a good place to start, but it is also a good idea to speak with us or some other lender who has extensive TIC experience. Another excellent resource is the website of Andy Sirkin, an attorney in San Francisco who specializes in TICs, at www.andysirkin.com.*

The most important differences between a residential TIC and a condominium are the ownership structure and the financing.

Nowadays, financing a condominium is as easy as financing a single family residence. Financing a TIC, however, is more complicated and generally more expensive. It is because of the more complicated ownership and financing issues that an interest in a TIC will be less expensive to purchase than an equivalent condominium.

What is a TIC, or tenancy in common?

In a TIC or tenants-in-common ownership arrangement, two or more people share ownership of a piece of real estate. Recently, TIC ownership has become more common. TIC arrangements are used by investors purchasing an interest in a property as part of a tax-deferred exchange, and by vacation homeowners who want to share the expense of owning a vacation property. Residential TIC arrangements are common in San Francisco, when prospective homeowners join together to purchase a multi-unit building in which to live.

In a residential TIC, each owner owns a specified percentage of the total building—not a particular unit in the building—and each owner's individual TIC interest can be conveyed to another party, or passed on as part of the estate if the owner dies. In a typical residential TIC arrangement, a group of buyers—either individuals or couples—come together to purchase a building having two or more living units. Under terms spelled out in a separate “Tenancy in Common Agreement” each buyer has the right to occupy one of the units, although they all own the entire building together.

TIC ownership has become widespread in San Francisco over the last ten years. Because a TIC unit costs less than an equivalent condominium, TIC ownership has allowed many people to enter the home market who would otherwise be priced out.

How is financing a TIC different than financing a condominium?

A condominium is a property which has been legally divided into individual parcels, each with its own parcel number, and separate property tax bill. Each owner has a deeded interest in one specific parcel— that owner's unit—as well as a shared interest in the common spaces of the condo project. The owner's individual condo unit can have its own separate mortgage loan, independent of any financing on any of the other condominium units. That unit, as a legally unique and deeded piece of real estate, can be sold or passed on to any other person.

In a TIC, each owner owns a percentage interest in a single property. Regardless of the number of owners, there is only one piece of property—the building itself—with one parcel number and one property tax bill. The right of any one of the owners to occupy a particular unit is not deeded, it comes from a contract, normally drafted by an attorney for the buyers, called a "Tenancy in Common Agreement." This agreement is used whether the building is financed using a single group loan, or whether each owner has an individual 'fractional loan' secured by his or her percentage interest in the building.

What loans are available for a TIC purchase?

There are two loans available for TIC purchases, a group loan and a fractional loan.

Group TIC Loans

Advantages:

lower interest rate
 lower monthly payment
 no prepayment penalty
 lower down payment

Disadvantages:

expensive to refinance
 more difficult to refinance
 each partner responsible for entire loan
 can make selling more difficult

Fractional TIC Loans

Advantages:

individual interest can be sold more easily
 not financially responsible for other partners
 group does not have to get a new loan when only one partner needs one

Disadvantages:

higher interest rate
 higher monthly payment
 may have expensive prepayment penalty
 higher down payment

With a group loan, all of the buyers of the property apply for a loan together. Conventional lenders will only do one loan on the entire property, with all of the buyers as co-borrowers on the loan. Although the buyers will be occupying separate units, they are jointly purchasing one property. There are several important issues with a TIC group loan that you should be aware of:

- **All of the borrowers qualify for the loan as a group.** From the lender standpoint, income and assets are pooled: essentially, the lender looks at the transaction as a single loan—which it is—with one borrower, the group. The dynamics of the group are very important. For example, one borrower with a high income but very little down payment can be compensated for by another group member with a low income but substantial assets. Also, the credit score of each individual is important because most lenders will use the lowest credit score in the group when pricing the loan.
- **Group TIC loans generally have more rigorous qualifications than individual condominium loans.** They may require some combination of more down payment, better credit, higher income, or more disclosure of income and/or assets. This is because the lender is looking at a much larger loan size than if each unit were being sold individually like a condo. If four borrowers are buying a \$2.5 million dollar building with 20% down, the lender is looking at one very large loan amount—\$2 million. This is also the reason that most TIC loans require an aggregate down payment from the group of 10% to 20%, not the 5% that is usually adequate for a condo purchase. However, remember that the group dynamics might allow very little down from one member if another group member is coming in with a sizable down payment.

- **Each member of the group, as a co-borrower on the loan, is responsible for the loan payment.** If the loan becomes delinquent because one borrower can't make their payment, the credit of each member is negatively affected. That's why it is important in a TIC to know the credit score, job and income history, and overall financial strength of your partners. Partners should be prepared to share their financial information with each other.
- **The primary disadvantage of having a group loan is the complications it presents when one or more of the TIC partners wish to sell their interest.** A few lenders allow partial assumability of a TIC loan. This means that if one member of the group sells his or her interest, another party can assume that person's interest in the loan for a fee. Always ask your lender if a loan with partial assumability is available.
- **Without partial assumability, the partners may have to get a new loan whenever a partner sells, which can be expensive.** If the loan does not allow partial assumability, it may be possible for the group to keep the original loan which has the seller as borrower, while the new partner simply makes the seller's payments. However, if the unit has appreciated, the seller's percentage of the group loan may not provide a loan large enough for the new buyer, unless the seller is willing to carry a second mortgage for the new buyer. In that case, the seller would not be able to cash out all of his or her equity at the time of sale.

Fractional Loans

With a fractional loan each buyer of the property applies for a loan individually, although there is only one lender making each of the individual loans.

- **A fractional TIC loan allows the individual members of the group to have their own separate loans,** secured by a deed of trust covering that individual's TIC percentage interest.
- **With a fractional loan, each member of the group qualifies for an individual loan based only on their individual qualifications.**

- **If a member of the group defaults, the lender forecloses only on the share of the individual who defaulted**, not on the group as a whole.
- **If a member sells their interest, the buyer must then go to the same fractional lender to get their own loan.** The buyer must qualify for a new fractional loan with the original lender. There are no other lending options.
- **Fractional loans generally have a substantially higher interest rate, and higher closing costs**, than a group loan, and they will usually have an onerous prepayment penalty.

With a group loan, most types of loans are available—hybrid loans with an interest-only payment, fixed rate loans, and ARMs, including negative amortization loans. With fractional loans only hybrids are available; an interest-only payment may not be an option. Most fractional loans require a three to five year prepayment penalty; most group loans do not.

Fractional loans have only become available in the past couple of years. The terms, availability, and cost of fractional loans may change rapidly if their adoption becomes more common. Again, if you are seriously looking at a TIC purchase, contact an experienced TIC lender early in the process.

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What do I need to know about refinancing?

Refinancing your mortgage is a powerful financial tool that can save you thousands of dollars when done thoughtfully and professionally. It's important to understand your choices, the timing, and how to evaluate any savings from a lower interest rate relative to the cost of the refinance.

If the lender is paying some or all of your closing costs, lowering your interest rate by as little as one-half of a point makes sense.

Try not to wait for the 'bottom'—most Wall Street pros miss it. If you wait for interest rates to drop, and they shoot up, you will have missed an opportunity to save a substantial amount of money.

Refinancing can provide an opportunity to extend your loan's fixed term so that you don't have to worry about higher rates down the road—by changing from a 5-year fixed to a 30-year fixed, for example. Conversely, if you are planning to sell your house in the next couple of years you may want to lower your rate and payment by refinancing into a shorter term loan.

If you need to tap your home's equity, and if interest rates are higher now than when you took out your existing mortgage, it may be better to simply get a home equity line of credit than to refinance, depending on the type of mortgage you have.

If you are older, have a fixed income and/or limited liquid assets, and have substantial equity in your home you may be looking for a way to tap that equity without having to sell. There are several options to consider, including a reverse mortgage.

These topics and more are covered in the questions that follow. The information in **“How do I shop for a mortgage?”** on page 7 and **“Which is the best loan for me?”** on page 17 will also help you find the best rate and terms for your refinance.

When should I refinance?

The rules on refinancing have changed greatly because of the availability of no-cost and low-cost mortgages, where the lender is paying some or all of the costs of refinancing. When you can refinance and it costs you little or nothing, it makes sense to refinance even if rates have only dropped marginally.

Some situations that might merit refinancing:

If you hear that interest rates have dropped, call your lender to see what the rate would be for a no-cost loan. Many people make the mistake of waiting for the 'bottom.' The time to refinance is when refinancing will save you money; if rates continue to drop, and you do not have a prepayment penalty, you can simply refinance again. If you are working with a competent mortgage broker, refinancing the second time will be fast and easy. And if rates move up after the first refinance, congratulations—you did catch the bottom!

If you are certain you will be moving within the next two years, refinancing into a no-cost adjustable rate loan might save you a considerable amount of money before you move. You may be able to cut your monthly payments by hundreds of dollars a month, knowing that you will be out of this new mortgage before its interest rate rises to the level of your current mortgage.

If you want to take some cash out of your property, refinancing may be the right thing to do. However, be sure to compare the difference in total monthly payment between adding a second mortgage or home equity line to your existing mortgage, and in getting a new first mortgage for the entire amount you need. If you have a low fixed rate on your first mortgage and you think that you will be able to pay off a new home equity line within a few years, it is probably better to keep your existing first.

What is a no-cost loan?

Closing costs are broken into two major categories, recurring and non-recurring. **Recurring closing costs** in a refinance are items that you would have paid even if you weren't refinancing: mortgage interest, property taxes, and homeowner's insurance. **Non-recurring closing costs** include all broker and lender fees including points, the appraisal, and title and escrow fees.

In a no-cost loan, the lender pays most or all of the non-recurring closing costs. You pay no points or loan fees, no appraisal or credit report fee, and, usually, no title or escrow fees. However, these loans always have a higher interest rate, if fixed, or some combination of a higher start rate, margin, or life cap, if adjustable, than a loan in which you pay the closing costs.

Consider a no-cost loan if:

- **You either cannot or do not want to spend the money to pay closing costs.** You may need the maximum amount of cash that you can take out in a refinance, or, if you are purchasing a home, you may want to keep your cash for moving expenses or remodeling.
- **You are only going to be in the property for three years or less,** not long enough to recoup your closing costs in the form of a lower payment. Remember, paying closing costs = lower rate = lower payment. If you pay closing costs of \$3500, and you save \$100 a month by paying them, it may make sense to pay them if you are going to keep that loan for 35 months or longer and if you won't have another refinance opportunity.
- **You believe interest rates will drop** and you will be able to refinance again within two or three years at a lower interest rate.

Avoid a no-cost loan if:

- **You have the money to pay closing costs and want the lower rate.**
- **You are fairly certain that you will keep your mortgage for more than three years**, and don't believe you will have a refinance opportunity.
- **You believe that interest rates are going to rise.**

If you are considering a no-cost loan, always compare it to a similar loan where the closing costs are not paid by the lender. Try to compare the no-cost loan with a similar loan that has no points—but you pay the closing costs—and one that has a one-point fee. How much are the closing costs the lender is paying? How much more are you paying for the no-cost loan in the higher interest rate and monthly payment on a hybrid or fixed-rate loan, or in the higher start rate, margin, or life cap on an adjustable?

What about a reverse mortgage?

Note: *for more detailed information, we recommend that you visit the website of the AARP at www.aarp.org*

A reverse mortgage is a home loan that you do not have to pay back, either monthly or in a lump sum, for as long as you or your co-borrower continues to live in your home. All borrowers must be at least 62 years of age to qualify for most reverse mortgages. **A reverse mortgage lets you convert the equity in your home into cash, without having to sell your home, or to repay the loan each month.**

You can receive the money from a reverse mortgage in several ways:

- **all at once**, in a lump sum
- **as a regular monthly cash advance**
- **as a credit line** that gives you the option of deciding the time and the amount of the money you need
- or **as a combination** of these payment methods

No matter how this loan is structured, you typically don't have to pay anything back until you die, sell, or permanently leave your home.

Normally, when you qualify for a loan, the lender checks your income and your assets before approving you. But with a reverse mortgage, since you don't have to make monthly repayments, the lender doesn't look at income and assets. **You can have a very modest income and still be able to qualify for a reverse mortgage.**

The federally-insured Home Equity Conversion Mortgage (HECM) is far and away the most popular program, with the loan amount, interest rate and fees regulated by the government. The disadvantage to HECM for many residents of northern California is the limitation on loan amount. Regardless of property value, HECM loan amounts can not currently exceed \$362,790. This may not meet the needs of someone who is sitting on \$1 million plus of home equity. Although there are other reverse mortgage programs with higher loan amounts, they are expensive, with high closing costs and interest rates.

Using careful planning and conservative assumptions about future interest rates and real estate appreciation, it may be possible to structure home financing that effectively works as a reverse mortgage. By taking cash out in a refinance with an interest-only fixed rate mortgage, investing that money conservatively, and then using a portion each month to pay the monthly payment and subsidize your income, you can continue to live in your house, and tap the equity build-up to make your retirement more comfortable. However, this should only be done carefully, and with the advice of an experienced financial planner and a good mortgage person.

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CREDIT SCORES

Borrower: _____

Co-Borrower: _____

You will need a tri-merge mortgage credit report. We can provide one for you at no charge.

EMPLOYMENT

Work Status (check all that apply): B = Borrower, C = Co-Borrower

- | | |
|---|---|
| B C
<input type="checkbox"/> <input type="checkbox"/> Employed receiving a W-2
<input type="checkbox"/> <input type="checkbox"/> Partner, income on Schedule E | B C
<input type="checkbox"/> <input type="checkbox"/> Self-employed, income on Schedule C
<input type="checkbox"/> <input type="checkbox"/> Investor: finance and/or real estate |
|---|---|

Do you own more than 25% of company?B _____ C _____

How long in primary line of work?B _____ C _____

How long with current employer?.....B _____ C _____

Any employment change, or significant change of income in the last two years? B _____ C _____

Current Monthly Income: B \$ _____ C \$ _____

Note: Using the same information, one lender may determine your income differently than another, especially if you are self-employed or had a recent job or income change. If you have questions, call us.

TYPE OF LOAN DESIRED

Type:

Loan Options:

- | | |
|---|--|
| <input type="checkbox"/> 30 year fixed <input type="checkbox"/> 7/1 ARM <input type="checkbox"/> ARM
<input type="checkbox"/> 15 year fixed <input type="checkbox"/> 5/1 ARM <input type="checkbox"/> Option ARM
<input type="checkbox"/> 10/1 ARM <input type="checkbox"/> 3/1 ARM | <input type="checkbox"/> No points <input type="checkbox"/> Interest only
<input type="checkbox"/> Points _____ <input type="checkbox"/> Negative amortization
<input type="checkbox"/> Prepayment penalty |
|---|--|

Cash out? _____ If yes, how much \$ _____

PROPERTY

Current estimated value \$ _____

Last appraised (month) _____ (year) _____

Last appraised for \$ _____

Improvements since last appraised _____

Current loans on property:

1st Mortgage \$ _____

Since (month) _____ (year) _____

Interest Rate _____

Type of loan _____

2nd Mortgage/Equity line of credit since (month) _____ (year) _____

Line limit \$ _____

Current balance line/loan \$ _____

- Property type: Single family Live-work loft
 Low-rise condo Multi-unit, # of units _____
 High-rise condo

- Property is: Primary residence
 Second home
 Investment property

ASSETS

Cash, money market, checking, savings, mutual funds, stocks and bonds \$ _____

Retirement, 401K, IRA, etc. \$ _____

Have the funds been in account for at least 60 days? _____

Other property owned: Investment Second Home

Estimated value \$ _____

Total loans on other property \$ _____