HOME BUYER'S GUIDE

TO THE FORECLOSURE MARKET


Contents

What is the foreclosure process?

When a bank forecloses on someone's house, it means that the person hasn't been able (or willing) to make payments on their home. Foreclosure is the formal and legal process where a lender may sell a property in order to recover the value of the mortgage, in an effort to recoup their investment. In some instances, the lender will simply repossess the property. It is important to note that the bank forecloses on a loan, not a property, so it is indeed possible to have more than one active foreclosure on a given property.

In order for the foreclosure process to begin, the borrower must default on their mortgage payments. Usually a lender will wait to start this procedure when the borrower has missed a few payments. Banks and lenders do not begin the foreclosure process lightly and the process is both lengthy and costly.

Next we will go over the steps involved in the foreclosure process.

Notice of Default

The first step for the lender is to file a "Notice of Default" with the public records. In some states a notice is also put up on the home, letting everyone know that the home is in default. *The exact process can vary from state-to-state. Refer to a REALTOR® specialized in working with foreclosures in your area for state-specific details.*

At this stage the lender hasn't actually started the foreclosure proceedings, but is threatening to do so. Lenders need to give the borrower 90 days to pay the back payments (and any penalties) to bring the loan current.

If the state requires judicial foreclosure actions, the lender will file a "lis pendens," instead of a "Notice of Default," which is a similar document. "Lis pendens" is Latin for "suit pending."

Some investors get a list of homes that have received a Notice of Default. They approach the owners directly, offering them a chance to avoid foreclosure by selling the property.

Notice of Acceleration

Next the lender will send the borrower a letter which gives a Notice of Acceleration on the loan.

This is a step the lender takes to enact a clause that is in the mortgage contract, called the Acceleration Clause, which allows them to call the entire mortgage due in full, now.

This can only be enacted if the borrower has defaulted on their loan. If the borrower makes regular payments, on time, the lender is not allowed to do this.

The reason lenders accelerate the loan is to foreclose on the entire balance, not just on the amount due. It is the only way that the lender could repossess a home and sell it.

How the foreclosure process ends

There are four basic ways a foreclosure can end:

1. The borrower is able to pay what they owe, reinstating the loan.

2. The lender grants a form of loss mitigation to the borrower.

3. The property is sold at auction.

4. The lender repossesses the property.

Usually, if the borrower is able to pay everything they owe, at any point in the foreclosure process, the lender will reinstate the loan.

There are a number of loss mitigation strategies a borrower may use:

- ***Forbearance:*** *this is where the borrower is allowed to skip a few mortgage payments, to ease the pressure. Forbearance must be applied for and formally accepted. Typically the missed payments are tacked on at the end of the loan.*

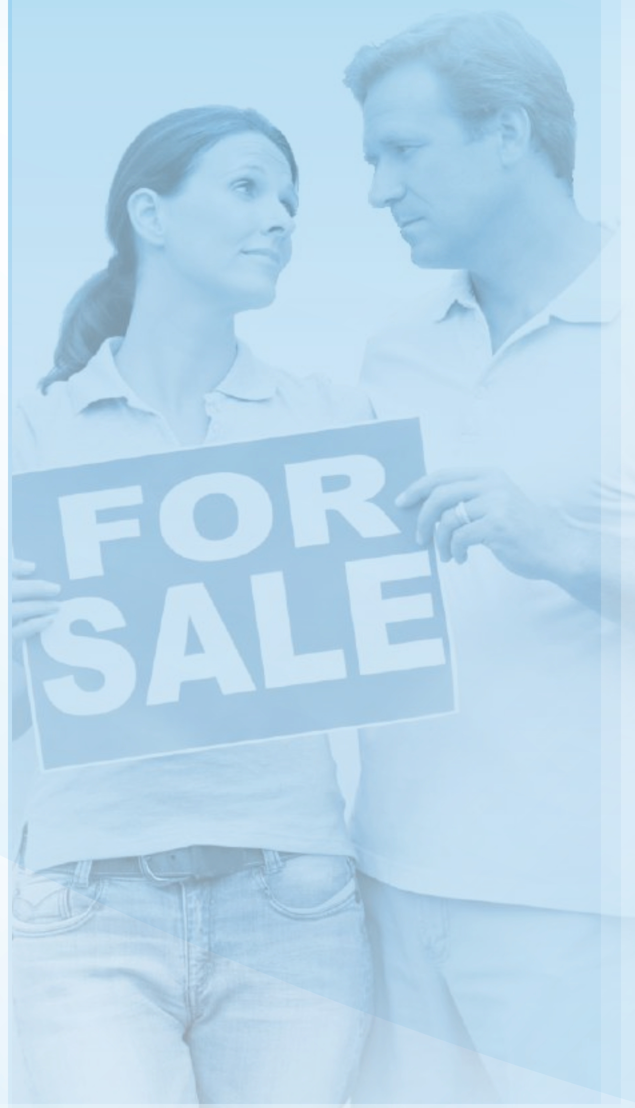
- ***Loan modification:*** *This is when the lender is willing to compromise with the borrower, giving them better loan conditions. Sometimes the lender lowers the interest rate, sometimes they decrease the balance. The borrower must apply for the modification and be accepted, but this is advantageous to both parties.*

- ***Short sale:*** *This is where the lender allows the borrower to sell the property for fair market value - but under the outstanding loan amount.*

- ***Deed in lieu of foreclosure:*** *This is where the lender agrees not to foreclose in exchange for the deed to the property. The owner agrees to walk away peacefully. This avoids a lengthy battle and any malicious destruction of the property.*

- ***Cash for keys:*** *This is similar to deed in lieu of foreclosure, but here the lender gives the borrower a small cash settlement to move out without destroying the property. Sometimes an added bonus is given if the borrower moves out quickly.*

How do people get into foreclosure?



In the following paragraphs, we will explore some of the leading factors that can contribute to someone falling into foreclosure:

- ***Negative equity***
- ***Death and divorce***
- ***Illness***
- ***Lack of planning***
- ***No Doc/Stated Income Loans***
- ***Lack of consumer education on mortgages***

Negative equity

Negative equity means that the borrower owes more on the mortgage than the home is worth. This is also called being “upside down,” or “underwater” on your mortgage.

Example: A home was purchased for $200,000 only to find a few years later it was worth $150,000.

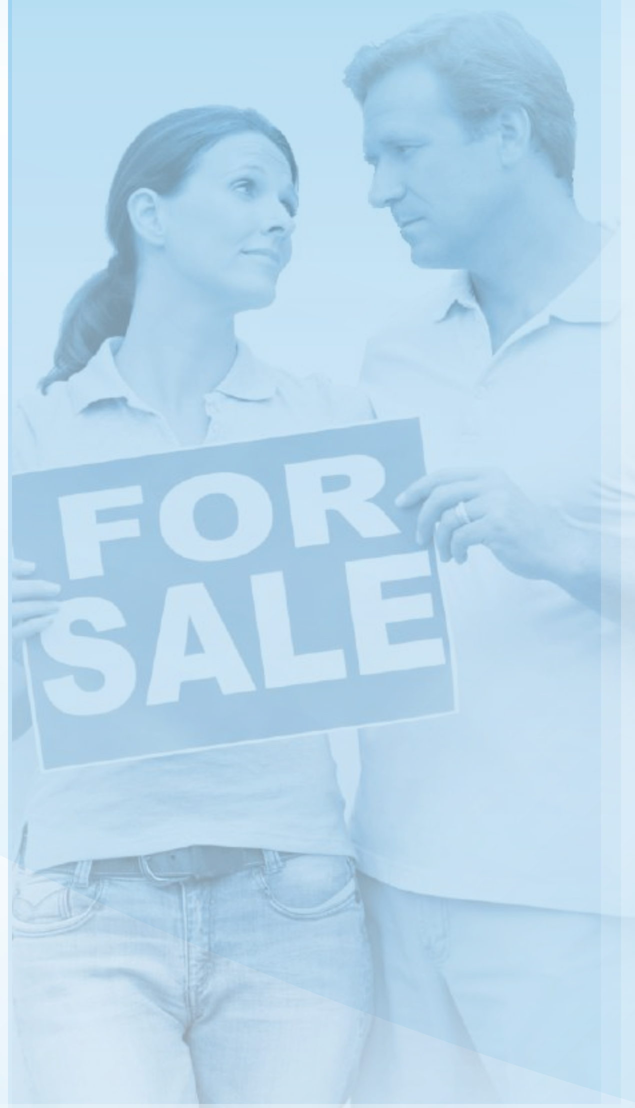
Even though the home’s current value was $150,000, the lender was still owed $200,000 – creating a negative equity situation of -$50,000.

Death or divorce

Death or divorce both can dramatically change the economy of a family. Both can be devastating and lead to the start of the foreclosure process.

Death can happen suddenly, leaving one spouse caught off guard with too many bills to pay. Unless planned for in advance, the surviving spouse is often unable to make the full loan payment.

With a divorce, usually one spouse will stay in the home and one will leave, but there oftentimes is a disagreement about who will pay the mortgage. Frequently, both marital partners are on the loan agreement, because both people's income was needed to qualify for the loan. When one leaves and refuses to make payments, the other is often forced to miss payments.



Illness

When a member of the family falls ill, it usually happens suddenly. If the breadwinner becomes seriously ill, they often lose their job.

Regardless of which family member becomes sick, medical bills can start piling up, making it difficult to make mortgage payments on time.

Lack of planning

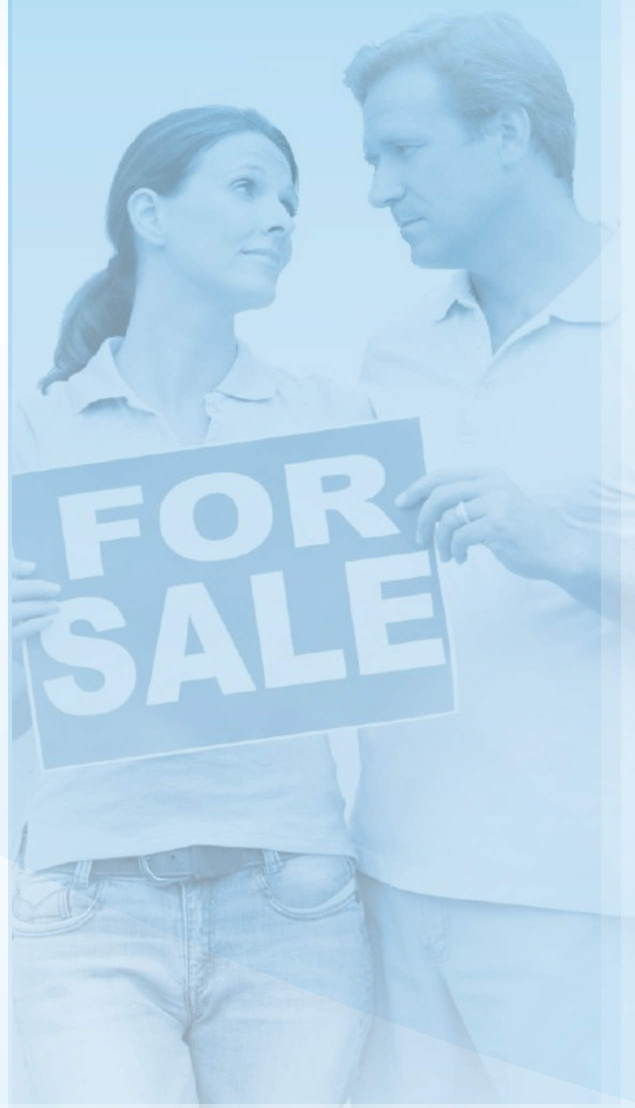
The lack of a solid long-term financial plan and sufficient cash reserves can also lead to foreclosure. If a household lives paycheck-to-paycheck without sufficient cash reserves on hand to mitigate unexpected difficulties, unanticipated negative life events can have a drastic impact on their ability to stay current on their mortgage.

No Doc/Stated Income Loans

Generally speaking, if a borrower had an excellent credit rating, oftentimes lenders would loan money with a simple verbal verification of income and assets, without a proper and thorough examination of substantiating documentation, i.e. "no doc" loans.

Because there was no thorough verification of a borrower's income and assets, many borrowers would lie about their income. The lender would crunch the numbers, and inform the borrower what their "stated income" should be.

When the value of the homes dropped, borrowers who were lent money through "no doc" or "stated income" loan products were stuck with mortgages they couldn't afford, and many were subsequently saddled with negative equity.



Lack of education about mortgage loans

Borrowers sometimes enter into a mortgage loan agreement with a lender not fully understanding what they're signing. Because of this lack of insight into loan and loan products, many borrowers thought they were obtaining one type of loan when in fact the actual product was very different. Many default situations that were caused by a borrower's lack of understanding were through the use of adjustable loan products and stated income loans. Many times, the interest rates would fluctuate dramatically on these loans, forcing a borrower to pay much more than they initially expected – leading to default, and eventually, foreclosure.

Your choices for foreclosure purchases

The subject of foreclosures can be very upsetting for people. However keep in mind that getting into the business of buying foreclosed homes can benefit you, the lender and sometimes the previous owner.

As discussed in the previous chapter, a home goes through various phases when it is in foreclosure. You can buy a home in each of these three stages:

- ***Pre-foreclosure***
- ***Auction***
- ***REO (Real Estate Owned)***

Pre-foreclosure

A pre-foreclosure refers to the status of a property in the early stages of being repossessed. The pre-foreclosure status begins when the lender files a default notice on the property. At the point of pre-foreclosure, the property owner still has the opportunity to pay off the outstanding loan balance or sell the property before it is foreclosed upon.

An option for property owners in the pre-foreclosure stage is a "short sale." A short sale refers to a type of transaction where the lender agrees to accept a payoff amount less than the outstanding balance of the loan. Typically, a short sale offering is worked out between the seller and their bank, with the ultimate say on contract acceptance and transfer of ownership residing with the bank(s) holding the loan.

More common nowadays, short sales can be tricky to navigate, and can take a much longer time to settle than a "regular" sale or REO sale. Having representation from a REALTOR® adept at navigating the nuances of a short sale is critical to a successful purchase as rules and processes can vary from bank to bank.

That said, the pre-foreclosure option has many advantages. You may be able to get a great deal on a property, and can help out a distressed homeowner. But remember to be patient with the short sale process as the lender is cutting their losses, while the owner is attempting to avoid a foreclosure.

Auction

While there is certainly an opportunity to get a great deal at an auction, there is also a lot of risk. Usually, properties sold at auction are sold "as-is, where-is." At the time of sale, auction properties are usually sold with no contingencies, meaning that a lot of research and due diligence must be done by the purchaser prior to purchase.

Most likely you won't be able to properly inspect a property before you bid. If you buy it and there are unseen damages, you're stuck with it.

Be sure to keep in mind that an owner usually has the option of paying the amount they owe in full, at times up to the last minute, in order to regain possession of their home. Because of this, auctions are often postponed or cancelled.

In order to really take advantage of a property up for auction, you must do a lot of homework. What is the estimated value of the property? Are there any liens? Remember that liens transfer with the property, not the people who owned the home, so if you buy a home with liens, you inherit the liens. Depending on your state, some liens may be erased by the public auction, while others won't (like tax liens).

You would need to become familiar with the auction procedures of your area before bidding on a property. You will usually need to purchase the property using certified funds, or have cash on hand.

As a final consideration, it can be possible that when a home is purchased at auction, the previous owners can still be residing in the home. This may mean your first action as the new owner will be to evict the old owners.

REO (Real Estate Owned)

A property which is classified as REO is owned by the lender. An REO property has completed the foreclosure process and didn't sell at an auction, and has been repossessed by the lender.

The majority of REO properties available for sale will be listed with a REALTOR® (also known as REO Brokers), so the process of purchasing an REO is not terribly different than purchasing any other home listed by a REALTOR®. The majority of REO properties are delivered by the banks to these REO Brokers who then have some period of time – usually 30-90 days – to evict any tenants, clean up the property and get it ready for sale.

It is a good idea to enlist the aid of a REALTOR® as your buyer's agent and do your due diligence on market conditions and outstanding liens. Bear in mind that most REO properties are sold "as-is" meaning the lender probably will not agree to pay for any material fixes – cosmetic or structural – prior to the sale. Additionally, many banks do impose their own specific conditions as terms of purchase, so make sure to understand those terms prior to consummating your transaction (terms can vary from seller to seller).

The Four Basic Steps for purchasing a home in foreclosure

Generally speaking, there are four basic steps you will need to take to buy a foreclosure property:

Step 1: Find a property in foreclosure

As part of this step, you really should find a good REALTOR® with experience in this area. Don't try to navigate these complex waters on your own. There are quite a few nuances and twists that vary from seller to seller and property to property.

Give your REALTOR® your requirements for a home. How many bedrooms do you want? What square footage are you looking for? Make a list.

You will need to do research. It is good to know:

- ***The estimated market value of the home.***
- ***The date and purchase amount when the property last changed ownership (Your REALTOR® should be able to get this for you).***

Your REALTOR® will give you lists of properties, but you can also search on your own. There are a number of ways to find good deals:

- ***REALTOR.com®***
- ***Real estate signs***
- ***Word of mouth and friends***
- ***Newspapers***

If you drive through neighborhoods you might see many signs that say "Foreclosure" or "Bank-Owned." Write down the address and agent name and let your REALTOR® contact them for you. It doesn't hurt to ask the listing agent if they have any homes they haven't put on the list yet. REALTORS® specializing in foreclosures sometimes have to wait a few weeks before listing properties (because they are waiting to get approval on the price).

Make sure to let your friends and family know that you are looking for a foreclosure home. There are so many people looking for ways to get out of foreclosure, you might land your dream home at a steal and help a friend in the process.

Newspapers and internet sites are flooded with foreclosures. It doesn't hurt to scan these periodically. Many lenders also have websites that list foreclosed properties that they own.

Step 2: Get a loan

If you want to purchase a home in pre-foreclosure or when it has become an REO, you can purchase the property with a loan. (Auction properties are not eligible for purchase with a loan). The lending environment today is all about documentation and verification, so be sure to have all the documents needed, ready to go.

Here are the basic documents that you'll need:

- ***Proof of assets*** *(2-3 months of bank statements)*
- ***Proof of income*** *(2 years of W2 statements and your most recent pay stub or tax returns if self-employed)*
- ***Identification*** *(driver's license or visa)*
- ***A copy of your credit report*** *(which your loan officer will pull)*

* *Documents and time periods vary by bank and lender. Please check with your loan officer for a comprehensive list.*

If you have special circumstances (like you're divorced or have a discharged bankruptcy), you may need to include other documents into the package you submit to your lender. Consult your mortgage consultant/loan officer to learn exactly what paperwork will be needed.

It is best to get pre-approved (rather than pre-qualified, which is far less thorough) for a loan early on, as it will speed up the entire process for you. When you're pre-approved, you know exactly how much home you can afford and will get a letter verifying that.

It is also a great idea to have your lender deliver you a property specific pre-approval letter – i.e. if you want to purchase 123 Main St., your lender can deliver you a letter stating you are pre-approved to purchase 123 Main St.

Step 3: Contact the owner (or trustee)

If the home that you wish to purchase is in pre-foreclosure and not on the market, you can contact the owner directly, or have your REALTOR® contact the owner directly on your behalf. If you don't know the current owner, you should write them a letter (or ask your REALTOR® to contact them).

If they respond to your letter, you may need to explain the benefits to them of short selling the property. Many people will be eager to avoid the stain of foreclosure on their record and some don't know their options.

If the pre-foreclosure is listed with a REALTOR® as a short sale, generally the property should be available to view and inspect

like any other.

Step 4: Put in an offer

In order to put in a realistic offer, you must know the following:

- ***What is the estimated market value of the property?***
- ***How much is owed?***
- ***Does the owner have other loans or liens?***
- ***What will be the cost of needed repairs?***

It is critically important to know the current market value of a property. Be sure to lean on the local market expertise provided by your REALTOR® to help you understand the local market and how it relates to the list price of the home you want to purchase.

If the house is still in pre-foreclosure, be patient. It can take weeks – and even months – before you hear back from a bank regarding your offer. Your REALTOR® can work with the listing agent in order to follow up and check status on your behalf.

If you buy a home at auction, you might not have the opportunity to do a title search or inspection. Since you must buy a property as-is, auctions are much riskier. Give yourself a buffer for unexpected repairs.

Go over all the information you gather with your REALTOR®, and they will be able to help you formulate a strong offer to submit.

Tips for purchasing a home in foreclosure

Find a REALTOR® with foreclosure experience

REALTORS® sometimes specialize in various areas of real estate. Some deal primarily with foreclosure properties, while others have never touched this area.

Create a list of questions and interview a few REALTORS®.Find someone that you're comfortable with and can talk to freely. It's always a good idea to get referrals from friends or associates who have bought a foreclosure property.

Have a goal in mind for your investment

Do you want to flip the home? Or do you want to keep the home for your family? Knowing your goal ahead of time is important. Before you start looking, be sure you know your purpose for this purchase.

Don't worry about "missing a deal"

Some people treat the foreclosure market a bit like a trip to Vegas - spin the wheel and close your eyes. It's important not to gamble. This is a huge investment!

Don't be overly concerned with missing the perfect foreclosure home. If you feel yourself rushing into a decision, step back and make sure all the research information aligns with your goals. Be patient, there are plenty of good deals out there.

Don't get caught up in a bidding war

It can be difficult not to get swept away by the energy and excitement of a bidding war. People sometimes don't want to "lose" and forget their goals and price parameters. Make sure your highest bid is in-line with how much you can afford and your pre-approval amount.

Do proper research

Do a lot of research and arm yourself with all the information you can find. It might be tempting to throw caution to the wind and just "go for it," but remember that this is one of the biggest investments you'll ever make. Be sure you know as much as you can about the property before you put in a bid.

You'll need to research the comparable sales in the area. If there are pending sales, see if your REALTOR® can call the listing agent and find out the accepted bid (they may or may not tell you). These figures will help you determine an accurate value of the home you wish to buy.

Of course you'd want to know if there are other bids on the REO property. You can massage your bid amount depending on the amount of bids, if any, a home has on it.

If you're unsure, walk away

If you are not certain about the numbers and aren't 100% sure of the repair costs needed, don't put in an offer. If you have doubts about the property, walk away. There are other homes to choose from and the last thing you want to do is rush into a decision, unsure.

Ask the lender to postpone the auction

If you're purchasing a home in pre-foreclosure, make sure to stay on top of the date of the auction. Don't assume that the lender will cancel the auction just because you have a contract to purchase the home.

If the auction is scheduled before your closing, make sure the lender agrees in writing to postpone the auction. If they make a mistake and sell the house, you will need to find a new home.

Be wary of seminars on how to buy a foreclosure home

There are plenty of sharks in the water, ready to gobble up people entering the foreclosure arena. Be wary of expensive seminars with outlandish claims.

Find a good REALTOR® to help you navigate these waters. It's good to educate yourself, but a lot of the seminars out there are of dubious quality.

Include an inspection contingency clause in your contract

Buying a home without an inspection contingency clause in your contract is risky. A home inspection contingency offers you a way out in case the house is need of more work than you can manage.

Ask the bank to make repairs

Most REO is offered on an "as is" basis. This means that the lender is telling you that they won't do any repairs on the home.

However, if after you do your inspection you find problem areas, it doesn't hurt to put in a request to have them make some repairs. They might accept, rather than lose the sale. It is always worth asking. Still, be prepared for a firm "no."

Make your offer easy to accept

When you're working with an REO, there will be no face-to-face contact with the owner. Your REALTOR® will need to send your offer to the bank. Make sure that you're pre-approved for a loan and include a pre-approval letter with your offer. Include all the paperwork, including letters of explanation you may need. Consult with your loan officer. It's important to have this package be complete. Make your offer easy to accept!

Consider different bid strategies

There are different strategies to bidding. One is to wait a little, step back and see who else bids. Perhaps you want to do a short time for contingencies. Talk to the selling agent. Ask their advice on bidding. This could give you an advantage over other bidders. Every home is different, and every strategy for purchase is different, so make sure you align your strategy with your objectives.

Glossary of Terms

Auction

When an owner defaults on a loan and the lender forecloses, the bank usually tries to sell the home at an auction. If the foreclosure is run through the courts, the sheriff's office will oversee the auction.

Cash for keys

Cash for keys is when a lender offers the owner, or in some cases tenant, money to leave the property peacefully and quickly.

Deed in lieu of foreclosure

A deed in lieu of foreclosure is another option for someone facing foreclosure. If there are no other solutions open to the borrower, they can sometimes work out a deal with the lender to allow them to give up the rights to the property peacefully, avoiding the stain of foreclosure on their record.

Default

Default means that a person has stopped making their mortgage payments and is not meeting their contractual obligations of the mortgage agreement. When a borrower goes into default on the loan, the lender may start the foreclosure process.

Flipping

Flipping refers to the practice of buying a home, and selling it quickly.

Forbearance

Forbearance means refraining from enforcing something which is due. In this case it is when the lender agrees to give the borrower more time, delaying their payments for a few months. This isn't a free gift, as the payment owed is tacked on to the end of the loan, but it does give the owner some breathing room.

Forbearance is one solution for a homeowner facing foreclosure.

Loss Mitigation

Loss mitigation is where a lender works with the borrower to help them avoid foreclosure. Forbearance, loan modification, deed in lieu of foreclosure and short selling are examples of loss mitigation.

Negative Equity

This is when a borrower owes more than the home is worth. It is also referred to as being "upside down" or "underwater" on a loan.

Non-judicial foreclosure

This is a foreclosure which is handled outside of the court system. Some states do not require judicial foreclosures.

Notice of acceleration

A notice of acceleration signals that the lender is enacting the acceleration clause in the mortgage agreement, which allows them to demand that the loan be paid in full immediately. This is one of the early steps a lender takes in the foreclosure process.

Notice of Default (NOD)

This is a notice, filed in a non-judicial foreclosure process, that the owner of a property has stopped making payments on their mortgage loan and is in default.

Pre-foreclosure

Pre-foreclosure is the period before the auction and after the notice of default has been filed. The owner still has time to repair the default with the lender and save their home. During this period the owner can short sell their property, avoiding foreclosure.

Right of redemption

In some states, the law gives the owner every chance to keep their home. The right of redemption gives the homeowner 10 days after the auction to buy back their home from the purchaser, for the price paid. This right varies from state to state.

Real Estate Owned (REO)

Real Estate Owned (also known as REO) refers to any properties owned by a lender. Usually these have failed to sell at auction. REO is also known as "bank owned."

Repossession

This is another word for foreclosure. It is when the bank takes possession on a home from a borrower who has defaulted.

Short sale

A short sale is when a borrower sells their home under market value in order to avoid foreclosure. The lender must approve the sale.