Information Edge Report January 2009

What You Need to Know If You're Thinking of Buying a Foreclosure House

Have you seen ads like these?

> Save 20-50% On Your Home
> Buy up to 60% Below Market Value
> Homes for Half Price!

Ads like these are pushing foreclosed homes. Buying a foreclosed home may or not be a "deal," however. The process of buying foreclosed properties is more complicated and has more pitfalls and risks than buying a regular new or existing home (without foreclosure problems) on the real estate market. If you're considering the option of purchasing a foreclosed residence, this month's report provides tips and points to help you be better prepared.

Information Edge tip: If you have never bought a foreclosure property, hire an experienced professional to assist you. Foreclosure laws vary from state to state and in some states from county to county. A real estate agent or lawyer with experience in your local foreclosure market will know the procedures and laws that must be followed and the pitfalls waiting for the unwary. The professional should work for you (buyer's agent/lawyer) not the sellers or other parties.

How does the foreclosure process work?

Although the specific laws and steps differ by state, foreclosure is the legal process by which a mortgage lender (or other lien holder) can take possession of a property when payments on the mortgage are in default in accord with the loan agreement. The process may be supervised by the courts or not depending on the state. The process occurs in several general stages.

Pre-Foreclosure Stage

When a homeowner misses mortgage payments, the lender takes action to ask the homeowner to bring the loan current. The steps may include phone calls, reminder letters, and a final demand letter. After a certain number of missed payments, a formal notice of default is issued to the homeowner and made public. This notice declares the lender's intent to sell the property in accord with state statutes to satisfy the debt. During this pre-foreclosure stage, a homeowner has several ways to satisfy the debt owed, including selling the home.

Foreclosure to Public Auction Stage

This stage begins when the lender takes formal steps to foreclose, typically with the notice of default. If the homeowner doesn't take steps to "cure" the default or legally delay the sale (as by filing bankruptcy), the lender takes steps necessary to sell the property at public auction. This auction typically takes place on the county courthouse steps but may be held in a county office or at the property or other specified location. The lender sets the first, low bid (often the amount of the loan(s) and fees owed). The highest bidder at the auction takes ownership of the property, unless the high bid is lower than the lender's bid, in which case the lender may take possession of the property.

Lender takes possession of the property

If the house does not sell at auction, the lender usually takes ownership of the property. These properties are typically called “bank-owned” or REO (real estate owned) properties. In most cases the lender, now owner, hires a real estate broker or agency to sell the properties on the conventional market.

Before Bidding or Buying: Thoroughly check out any foreclosed property and related issues

Buying a foreclosed property can be risky and full of surprises. In order to reduce your risk, you need to find all the information you can about the property before you make an offer or bid. But there’s a catch. For properties in foreclosure, adequate access to information and/or time to get that information may not be available. A smart buyer, however, will take these steps:

Conduct a title search. A title search will determine if there is a second mortgage, unpaid property taxes, or other debts secured by the home (liens). In order to get a clear title to the home, you (or somebody or some process) will need to pay off or satisfy all the liens.

Get the home inspected. This step is important but not always possible. As money gets tighter and tighter, homeowners typically don't fix problems or perform maintenance. With a home inspection, you'll know up front what kind of repairs the home will need.

Get the market value. What are the comparable market values (comps) for the home? Without this information, you won't know if you're getting a bargain or paying too much. (Also what do you know about the neighborhood, schools, etc?) Also note that neighborhoods or developments with a number of foreclosed homes may have generally depressed or falling values, so be sure to get the most recent comps.

Arrange your financing. You need to get pre-approved for a mortgage before you start shopping for a foreclosed home. This is very important because some lenders won't finance a foreclosed property. For those that do, you need to know the criteria that the property must meet in order to get the mortgage. If you plan to buy the property at auction, you’ll typically need the total purchase price in cash.

Information Edge tip: It's very important that you know and understand the foreclosure laws that apply to the property. For example, some states have a redemption period (usually a few months but could be a year or more) in which the former owner can reclaim their foreclosed property, even if a new owner has taken possession of the property.

Potential advantages and risks of buying a foreclosure home

Here are some of the potential advantages and risks of buying a residence at the three stages of foreclosure described earlier.

Pre-foreclosure

At this stage the owner is in default on the mortgage (usually payments are at least 90 days late) but the public foreclosure notice has not been filed. You deal directly with the owner to buy during this period. The homeowner may be advertising the home “for sale by owner” or working with a real estate agent.

Potential Advantages

- The owner may be willing to negotiate a sale especially if they end up with some cash.
- You have time to do the appropriate research—title search, comps, inspection—before negotiating the sale.
- You may be able to buy the property through a "short sale," particularly when the appraised market value of the home has fallen below the mortgage owed on it. A "short

sale" occurs when the lender agrees to accept less than what is owed in order to help the financially distressed owner sell the property.

Potential Risks

- You'll be dealing with an owner who may be in denial about his/her financial situation.
- You may not be able to get accurate information about mortgage amount, other liens, or condition of the house.
- The house will have to be bought "as is." The owner typically will be unable or unwilling to make repairs.
- There may be additional liens on the house that will need to be paid off.
- This is the stage where the "foreclosure rescue" scam artists respond in droves. You don't want to be taken for one—in some states you can easily run afoul of protective foreclosure laws.

Public Auctions

At this stage, the lender has carried out the formal foreclosure, the property sale date and place are made public, and the property is sold through a public auction. Because there is almost no time (or means) to check out the property, buying at auction can be the riskiest for the inexperienced foreclosure buyer.

Potential Advantages

- You might get a property for less than current market value.
- In some states, second mortgages and other liens are wiped out. (Tax liens are not.)
- You don't have to deal directly with the owner as in pre-foreclosure.

Potential Risks

- You may pay more than the property is worth.
- Any back taxes will have to be paid off by you, the buyer.
- You usually have to pay cash or with a cashier's check. Some states allow 30 to 60 days for an auction buyer to complete payment, enough time to obtain a mortgage.
- The house is bought "sight unseen" and "as is." That is, you don't have an opportunity to see the property nor can it be inspected prior to the auction.
- You might need to evict the current residents from the home. Sometimes dispossessed residents damage the interior before leaving.

Bank-owned or Real Estate Owned (REO)

At this stage, the lender now owns the property and typically markets it through a real estate agency. The lender may or may not have carried out neglected maintenance. The lender typically will have clear title to the property. From a potential advantage and risk point of view, there is much to recommend this approach if you wish to buy a foreclosure property.

Potential Advantages

- You have time to do the appropriate research—title search, comps, inspection—before negotiating the sale.
- You may be able to get favorable financing terms from the lender who owns the property.
- All liens on the property have usually been satisfied.
- In many cases, the lender may have performed maintenance and made some repairs.
- You may be able to negotiate price.
- There are no residents to evict.

Potential Risks

- The property is bought "as is." It may have been empty and on the market for a long period of time.
- Don't necessarily expect a great bargain. You may pay close to a fair market price. Only properties that need a lot of work may be available for well below the market price.

In the current depressed real estate market, lenders in some regions have auctioned off their properties because they hold so many. These auctions differ from the public auctions mentioned above in that you can check out the properties and may have time to arrange financing.

Bottom line

Buying a foreclosure home is not a quick and easy way to save money. But if you are willing to take the time and do the work with patience, and persistence to minimize the risks and find the right property, buying a foreclosure home may work for you.