The Basics

The safest ways to buy foreclosures

Low interest rates and fast appreciation lure bargain hunters to homes facing foreclosure. You may pay less than market value, but not much less -- and the research can be daunting.

By Bankrate.com

With interest rates at record lows and the stock market looking too perilous for small investors, many people are putting money in an asset they understand -- real estate.

One of the best places to invest is in foreclosures and bargain residential real estate.

The current market conditions make it a perfect time for a small investor to purchase one or more foreclosure properties for their private residence, rental or resale. During economic downturns, more upscale homes go into foreclosure, so the notion that foreclosure homes are only available in crime-ridden areas is inaccurate. Beachfront and homes in affluent areas are part of the mix of foreclosed properties available.

But anyone considering buying a foreclosed home should forget about paying pennies on the dollar.

"You can buy foreclosures for as cheap as 30% or 40% below market, but most foreclosures sell for 5% below market," said John T. Reed, editor of Real Estate Investor's Monthly, a newsletter based in Alamo, Calif.

Yet the savings may be twofold if the property is purchased from the lender who holds the mortgage that's in default. That lender may be willing to waive some closing costs, maybe even offer a break on the interest rate or the down payment.

Investment of time

A novice must learn to navigate the foreclosure process. But Todd Beitler, owner of the Real Estate Library in Boca Raton, Fla., says the time and effort can translate to savings. "If somebody spends 10 hours a week for five weeks to do research, it's worth it."

For most consumers, however, the foreclosure process can prove daunting, Reed says. Good buys are available, but they require research, preparation, patience and persistence.

The foreclosure process starts when a property owner falls behind on mortgage payments. Many owners of homes that go into foreclosure have been struggling financially for almost a year before they give up, which usually means that the house has not received needed repairs or general maintenance for a while.

This may include everything from missing light bulbs to roof leaks. Tree limbs in front yards, broken appliances and windows, and dirty carpets, floors and walls are found in even very-affluent area foreclosures.

This can be a boon -- or boondoggle -- for a buyer. Houses in poor condition might fetch bargain prices, but repairs can boost the cost again. The first rule of real estate, "location, location, location," applies in these situations. If there is trash in every room of the house, but the foreclosure is in a good area with high property resale values, hold your nose, walk through the entire house and consider making a low offer.

Reading assignments

When a lender decides to foreclose on a property, a notice of default or a *lis pendens* (Latin for "lawsuit pending") is filed, depending on the state. This document is a public record, and for buyers, it's the first step in locating a property in foreclosure. A buyer looking for foreclosures also can buy magazines and newsletters that list properties in default.

Once a home has been located, search public records. Look for liens on the property, since they can drive up the purchase price. Liens typically are placed on a house for unpaid property taxes. Also check assessed values and sale prices of neighboring properties.

Research local state foreclosure laws, since they differ. Some states -- such as Florida, New York, Ohio and Pennsylvania -- require the lender to sue the borrower and get a court order for the sale of the property, a process known as judicial foreclosure. Other states -- including California and Texas -- follow the non-judicial foreclosure process, which doesn't require a lawsuit.

For novice investors, buying from the lender is the safest way to buy. Most foreclosures are taken back by the bank during auction, Beitler says. While well-located homes in good shape generally don't sell for deep discounts, rundown properties can be sold more cheaply.

Often, the banks hire a real estate agent and sell foreclosed homes in the traditional manner, Reed says. But sometimes buyers can succeed by pestering bank loan officers with low offers.

Buyers might try low-balling the lender's REO (for "real estate owned") officer shortly before the nonperforming assets have to be reported to supervisors, Beitler says.

The safest deals

Bank-owned properties offer the safest deal for inexperienced foreclosure buyers, Beitler says: "There's no risk. There are no taxes, no liens, no tenants to evict."

A lender that's eager to sell might be willing to offer attractive terms, says George Tribble, broker of record at Jetstream Mortgage in Oakland, Calif., and past president of the California Association of Mortgage Brokers.

The lender might offer to finance the property at a below-market rate or with a lower-than-usual down payment. Because the bank already has done an appraisal, the buyer might not have to pay an appraisal fee, Tribble says. And lender deals typically include title insurance, which removes much of the risk that accompanies buying homes earlier in the foreclosure process.

Hidden foreclosures

Not all foreclosures are previously owned homes. Some foreclosed homes are new. These homes are not as easy to identify and rarely appear on national lists.

In some areas, the slow economy has left many builders of new midscale and upscale homes at the end of their construction-loan periods without finding buyers for their homes.

In these cases, the banks that issued the construction loans take possession of the homes and attempt to sell them, using real-estate agents to handle the deals.

These, too, are foreclosures. They are "hidden" foreclosures because no one associated with the sale of these properties will refer to them as foreclosed homes.

More daring investors can find other points in the process to buy homes, like just before foreclosure. The buyer finds a homeowner about to go into default. The homeowner doesn't want to lose all of the equity in the property, so accepts a portion of the difference between the equity and the home's market value.

Pre-foreclosure buys offer bargains but demand persistence. That's because creditors are often hounding owners at this stage. "Trying to get through to the homeowner is virtually impossible," Beitler says.

If the homeowner is contacted, the buyer could be in for a surprise, Reed adds. Homeowners in default might not have phones or electricity, and they might have a variety of personal and legal problems. What's more, they probably need somewhere to live before they can move out of the property the buyer wants.

This is a high-risk, high-reward proposition, and it's not for first-time foreclosure buyers, Beitler says.

The auctioneer

Most auctions take place at the county courthouse steps, and they pose disadvantages: Buyers might not be able to inspect the property, and they'll have to put up the entire purchase price the same day.

The U.S. Department of Housing and Urban Development also runs auctions to unload homes it has acquired through defaults on federally backed mortgages. There aren't a lot of steals in this process, according to a study by Tim Allen, a real estate professor at Florida Atlantic University.

Allen tracked sales at a HUD auction in Florida in 1998; he found that buyers paid prices very close to assessed value. Beitler agrees that there's a "frenzy" at HUD auctions that can push prices to unreasonable levels.

The cost of getting started

With good credit, many banks will loan the full price of the foreclosure or more. If the home is to be used as a rental, many banks will require only a 10% down payment.

Individuals with a large amount of equity in another home may get a line of credit from their bank to purchase a foreclosure. When they convert the line of credit to a mortgage, no down payment may be required.

Foreclosure homes bought in good areas at below market values that appreciate annually can be a sound investment strategy for many investors. The appreciation of the homes is tax-exempt until the home is sold. If the home is a primary residence, the appreciation may be tax-free.

Homes used as rental properties give most investors valuable tax deductions while the house increases in value and builds equity. With many stock portfolios down, foreclosure real estate investing may be the alternative many people are seeking.