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PART 2 OF A 3-PART SERIES

PITFALLS OF TRUST DEED INVESTING: LOAN-TO-OWN UNDERWRITING

by Carrie Cook

Trust deed investing is generally considered a safe investment, but there are risks—just as there are for any investment. In this three-part series, we are tackling some of those risks. In the November/December issue, we addressed conflict of interest. In this issue, we'll look at loan-to-own underwriting. We'll conclude the series in March/April with the third pitfall: lack of diversification.

PITFALL #2 - LOAN-TO-OWN UNDERWRITING

In the loan-to-own underwriting scenario, the mortgage broker focuses solely on the loan-to-value of the property. Why would a mortgage broker only focus on the loan-to-value when underwriting a loan?

There are a few reasons. The first reason goes back to the first pitfall: conflict of interest. The mortgage broker is only acting in the capacity of a broker. Orginate, fund and done could also imply predatory lender. What this means is the broker determines a loan-to-value to be so low that investors imply there is no way they could possibly lose money on the investment and, unfortunately, it is sold that way to them. This ensures the loan will fund and the mortgage broker will get paid an origination fee.

Unless you understand the valuation methodology of how the loan-to-value calculation was determined, many of us would not know any better than to think, "Why not invest?" Loan-to-value is a speculative determination at best, prescribed by a few methodologies. Keep in mind that some mortgage brokers are governed by regulatory bodies that determine how this calculation can be marketed to potential investors. Yes, you read that correctly: the governing agency may be determining the loan-to-value.

Let's discuss this further. Some regulatory agencies determine the acceptable valuation methodologies that mortgage brokers must use when marketing a trust deed investment. In some cases, these valuation methodologies include only a third-party appraisal. So, if you happen to have an appraisal completed by a less-than-average, first-time appraiser, you may be banking your funds on their valuation.

We are not here to discredit appraisers who are unprofessional and not following the standard code of conduct rules to follow, but it is important to realize that every appraiser will determine a different value for the same property. Which one is accurate, and how can they be different? The difference in value from one appraiser to another could be as much as 50 percent higher or lower. That will obviously have either a positive or a potentially negative impact on what you thought was a rock-solid investment based solely on the loan-to-value.

Aside from the appraisal, what other valuation methodology did the mortgage broker perform? Do they know something you do not? This is where you should be cautious of a mortgage broker's hidden agenda. The phrase loan-to-own has various meanings. Watch out for those who have an intent to lend on a property with the hope that the borrower defaults on their obligation, thus allowing the mortgage broker to quickly foreclose and sell the property at a significant gain to the mortgage broker, not you. To protect yourself, read the loan servicing agreement the mortgage broker provided. This document should disclose the charges the mortgage broker assesses and the use of proceeds from the sale. If the document does not clearly define this information, require that it be provided to you in writing, with the ability for you to have access to the final closing statement.

When this type of mortgage broker is underwriting the loan, the most important thing to them is to underwrite it with a very low loan-to-value, because they want to take that property back. That is their goal. The broker doesn't focus on the borrower's ability to pay or the exit strategy. That's a big pitfall for you if you are an investor and the exit strategy has not been considered. Why? Because all the mortgage broker is looking at is that low loan-to-value and potential back-end equity return they will get.

In this situation, the mortgage broker touts that the low loan-to-value is your insurance plan, so that if something goes off track with the performance of that loan, you're collateralized at a low low-to-value. That is true, but there's no focus on the borrower's ability to pay or the exit strategy, increasing the risk for investors, rather than decreasing it. Instead, the mortgage broker wants the borrower to default on the loan, so they can foreclose on the loan.

They foreclose and take that property back. Then on the back end when they sell the property, they will be participating in an equity paycheck. As the investor, you are the one who is responsible for getting that property back; you're the one who will be coming up with the fees to pay to take that property back or hold on to that property. That means you might incur expenses along the way.

That's a huge pitfall. You have all the skin in the game, not the mortgage broker. You are positioned, if there is a downturn in the market, for potential losses. Even if there's not, you'll pay those fees upfront, and then the mortgage broker will sell the property and return your fees and principal, but he'll keep a portion of the equity or all the equity from the sale. That is a second payday for those types of mortgage brokers. They get paid

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upfront to fund the loan. Then, after you have paid the expenses to get your property back, they sell the property and that equity is a second payday.

SOLUTION # 2 - LOAN-TO-OWN UNDERWRITING

What is the solution to loan-to-own underwriting? It is loan-to-own underwriting. How can the pitfall and the solution be the same?

Loan-to-own underwriting is the value of the property in relation to the amount of the loan. For example, a $1,000,000 valuation based on a broker price opinion (BPO) with a $700,000 loan on the property equals a 70 percent loan-to-value. It is very important in the underwriting process, but it is not the only consideration.

A mortgage broker should consider the borrower's ability to pay and exit strategy to ensure that the loan will be beneficial to both the borrower and the investors. You do not want to underwrite the loan so that the borrower fails. A good mortgage broker will ask, "What if we have to take a property back?" not "We hope to take the property back." A good mortgage broker will have a contingency plan in place, where the loan-to-own strategy would come into play if the borrower defaults. A good mortgage broker has the confidence and experience to maintain a pool of funds allocated for these situations. They will be able to outlay the expenses upfront, instead of doing a capital call to the investors, with the confidence that recouping those outlaid funds will be returned upon the sale of the property.

Although a good mortgage broker would look at it from an equity perspective, they would not look at it as an equity play so that they could make equity profit on the back end themselves. They know that with the built-in equity, they can recoup their fees and expenses and return 100 percent of principal to investors, and possibly back-owed interest. Further, if there is additional equity, it does not go to the broker; it goes to the investors. Loan-to-own could have two different strategies in underwriting. You need to take a hard look at the mortgage broker before investing and identify whether their loan-to-own strategy is one that is a benefit to the investor. ●

ABOUT THE AUTHOR

CARRIE COOK

Carrie Cook is the president of Ignite Funding; CEO of Preferred Trust Company and COO of iManagement Group. Since her appointment at Ignite Funding, Cook has led the team to fund more than $315 million in loans with investor capital. Cook currently manages a capital client database totaling more than $85 million in real estate investments and is a licensed mortgage broker with the Nevada Mortgage Lending Division. As chief executive officer of Preferred Trust Company since August 2014, Cook redeveloped the custodial services business, ensuring clients effectively and accurately utilize their retirement funds to invest in alternatives such as real estate, metals and LLCs. Cook oversees the custody of approximately $250 million in client investments and cash holdings. As the COO of iManagement Group, she specializes in managerial services of investment funds.