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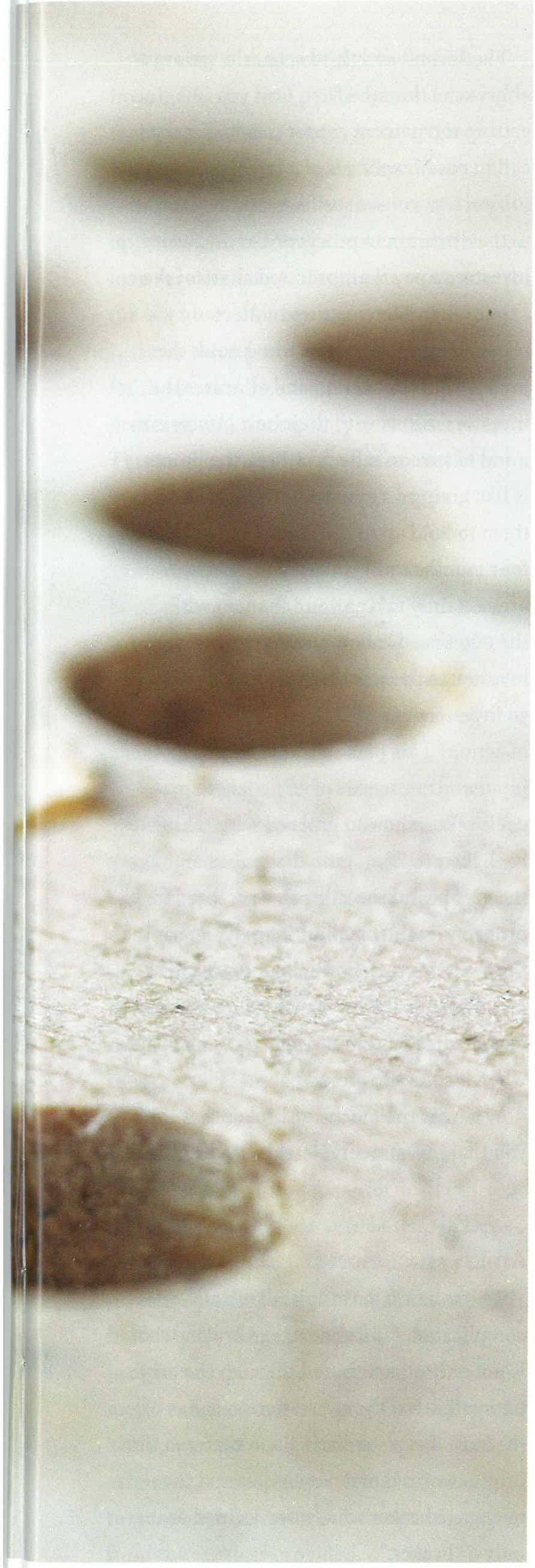

Pitfalls of Trust Deed Investing

PART 1 OF A 3-PART SERIES Conflict of Interest

by Carrie Cook

The comments are all too familiar.

"It's too good to be true..."

"You're going to lose all my money in that real estate deal..."

"Trust deed investments are for suckers..."

"Real estate investing is too much work, with minimal financial reward..."

If you know what the pitfalls of trust deed financing are, then you will know how to avoid them and have a better chance of experiencing real estate investing success. There are three major pitfalls and solutions every aspiring real estate investor should understand:

1. Conflict of interest
2. Loan-to-own underwriting
3. Lack of diversification

Trust deed investing is generally considered a safe investment, even safer than traditional investments. However, like any investment, there are risks to investors and borrowers. In this three-part series, we will start by tackling conflict of interest. We'll tackle loan-to-own underwriting and lack of diversification in subsequent editions.

PITFALL #1 – Conflict of Interest

A conflict of interest may arise with how and when the mortgage broker is paid. Does the mortgage broker consider the borrower or the investor to be their client? Can it be both? Should it be both? That is for you to decide.

Mortgage brokers seek, or are approached by, homebuilders and developers (borrowers) who need financing for their real estate project(s). Mortgage brokers also advertise for investors to lend their money to these borrowers with the intent to invest in a collateralized real estate investment earning passive income. The mortgage broker serves as the middle person in the real estate transaction to bring the borrower together with the investors to fund the real estate transaction. This is a standard practice with mortgage brokers who offer trust deed investments.

The conflict of interest occurs when a mortgage broker arranges the closing of the transaction to include an origination fee at a rate of 6 to 10 percent of the loan amount. This may not seem like much, but when you look at how this correlates to the payday for the mortgage broker, it may begin to matter to you. A $3,000,000 real estate transaction at an 8 percent origination fee charged by a mortgage broker equals $240,000. This is a lucrative payday for the mortgage broker, even before the investment performance of the real estate loan. This is not to say the mortgage broker should not get paid for originating and underwriting the loan. The concern arises when the mortgage broker does not service the loan and instead passes the servicing on to another company. Essentially, the mortgage broker is getting paid upfront and walking away with $240,000. Why not stay involved? The mortgage broker should know the loan better than anyone else since they completed the underwriting process and should be able to stand behind that loan.

If the mortgage broker is getting paid upfront by the borrower to sell the loan to investors and has no interest in the loan performance, then the broker is only incentivized to sell the loan to investors. If the broker is not servicing the loan, their client is the borrower, not the investor. In that case, what is the incentive to the mortgage broker to uphold quality underwriting standards? What's their incentive to make sure the investors will get their interest paid on time and their principal returned? There isn't any. This type of mortgage broker's job is over before your investment begins. They outsource the servicing of the loan and move on to the next real estate transaction. This is referred to as *originate, fund and done.*

If you are the investor, what happens next? The mortgage broker has outsourced the servicing to another company to collect payments from the borrower. The loan servicer is responsible for collecting the payments from the borrower and earns an agreed-upon servicing fee, distributing the remaining interest payments to the investors. If the borrower continues to make regularly scheduled interest payments, everything is great.

But, what happens if the borrower stops making payments? You won't receive your regularly scheduled interest payments, and the servicing company won't get their fee for servicing the loan. When the servicing company stops getting paid, they have a few options. They can sell the loan to a collection company, communicate to the investors that they need to send in an assessment of costs to the servicing company to attempt collection of the property, or hand the loan over to the investors and suggest they find an attorney to begin the foreclosure process.

If the loan is sold to a collection company, the company will charge you to sell the loan. A little research will tell you that they will collect a commission of up to 6 percent upon the sale of the property in addition to recouping any hard costs they spent to take back the property.

When do you see your original invested amount returned to you? That depends on the sale price the collection company negotiates for the property. This amount could also be defined by the market conditions at the time. If the market conditions are good and the property sells above the original loan amount and there are additional proceeds from the sale after the 6 percent commission and the hard costs, then the collection company may return 100 percent of your original invested amount and keep the rest. Keep the rest? Yes, that is the reward they get for doing a good job.

The second and third scenario are arguably worse than the first. Can you imagine getting 100 percent consensus on a capital call to cover expenses of a foreclosure, or 100 percent consensus from all investors as to the direction to proceed? Getting every investor to pay their prorated share of the expenses and having them collected by a reputable representative who knows the proper course of action and allocates the investors' funds with their best interests in mind to successfully take back the property is like giving a 2-year-old $100 and asking them to hold on to the money for you for four months until you ask for it back. You are certainly taking your chances with the outcome. Or how about electing one investor as the representative for a group of 50 investors to determine the best course of action? This person would be taking the input and consensus of 50 people to make decisions on how to proceed with taking back the property, cost allocations amongst the group, and the sale price accepted for the property—which will ultimately determine the capital return to the investor, good or bad. When is the last time you heard a group of 50 people who were all on the same page when it comes to money?

Where is the mortgage broker that sold you that investment? Nowhere to be found.

SOLUTION #1 – An Invested Mortgage Broker

The solution to this pitfall is not complicated. Find a mortgage broker who is not only compensated through the origination fee, but the actual performance of the loan. Learn to distinguish between the originate, fund and done types and the mortgage broker who is not defined as only a "broker."

Working with a mortgage broker who is invested in the loan performance defines the mortgage broker not only as an originator but also as a loan servicer. This distinction is important because they are not just paid upfront. This mortgage broker is also the loan servicer and will continue to work with the borrower's and investors' best interests. Just as a third-party loan servicer gets paid for the service, so too does the mortgage broker now in the capacity as loan servicer. This implies that if the loan is not performing, the loan servicer is not getting paid either. You now have a mortgage broker/loan servicer acting in your best interest, beyond the point of funding the loan. Keep in mind that no one knows the details of the property or borrower better than the mortgage broker who did the analysis of underwriting the loan.

There are a lot of services a mortgage broker can offer. An investor-minded mortgage broker will offer cradle-to-grave services that include but are not limited to: underwriting, origination, capital fundraising, loan servicing and collection/disposition of a property should the need arise. Are there mortgage brokers who provide these services under one roof? Yes!

Why would they perform these duties? Because it is good business. A mortgage broker who is willing to perform all those duties implies they are staffed with diversely skilled professionals who believe in the investments they are offering. They are not in it only for the origination fee. Mortgage brokers who handle a trust deed investment with the cradle-to-grave mentality also spread out their income earned from origination and loan servicing to create a reasonable, yet consistent, stream of income from the services provided.

This mentality aligns the mortgage broker's interests to their investors. If the loan is not performing, they are not getting paid.

As with all investments, there are inherent risks, and you must consider the "what if." If the loan pays interest and pays off as most do, then great. Your concern should not be this scenario. Your concern should be the scenario of a borrower not making the regularly scheduled interest payments. How is that situation handled?

Because the mortgage broker is aligned with the investor in this scenario, the mortgage broker maintains contact with the borrower throughout the duration of the loan. Typically, the mortgage broker provides the borrower a payment schedule that includes a due date for interest payments and a grace period before action is taken to secure the property. As the grace period nears, the mortgage broker will be in contact with the borrower to determine if an issue is imminent or if the payment is in route. If the borrower for any reason is unable or unwilling to make the interest payment, the mortgage broker who is cradle-to-grave will communicate to the investors and propose the best course of action to secure the real estate asset.

This process is completed in a controlled environment, unlike the alternative defined in the pitfall. Remember, this is a mortgage broker who has the best interest of both the borrower and the investors. The mortgage broker acting in the capacity of loan servicer gathers all the intel from the borrower to present to the investors in a communication that also includes a ballot to allow the majority loan holders to determine the best course of action—either to proceed with the borrower and/or to ultimately take back the property through foreclosure or Deed in Lieu.

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Upon the majority consensus from the investors, the mortgage broker turned loan servicer now takes on a third role—default loan resolution coordinator. In this capacity, a good mortgage broker stands behind the loan they underwrote and ultimately sold to the investors. A mortgage broker who is a default loan resolution coordinator has a vested interest in making sure investors get as much of their original invested amount returned as soon as possible. In some cases, the mortgage broker will pay for the expenses to take back the property on behalf of the investors, instead of doing an investor capital call, as the mortgage broker works to resolve the default. It costs approximately 3 percent to 5 percent of the original loan amount to foreclose on a property. If the mortgage broker funds the costs of the foreclosure process, they are invested in the outcome. They're getting paid when investors get paid. When they sell the property, the mortgage broker will recoup the funds outlaid to take back the property on the investors' behalf. This is a really important point in that the mortgage broker as a company has taken the proper steps to prepare for the "what if."

Remember, it is not a matter of if a loan will go into foreclosure, it is when. You are fooling yourself if you think you will not experience a real estate investment that is subject to default or market correction. It will happen in your investment lifetime. It is how you or the mortgage broker reacts to the situation that matters. When it does happen, a mortgage broker who acts in the capacity described above is the type of mortgage broker you want to be investing with. Make sure you ask the mortgage broker what their default rate has been historically and their track record for recouping investor capital.

Not all mortgage brokers are the same. Do your research and find a mortgage broker who underwrites, originates, funds, services, collects and sells a property should the need arise. This is a mortgage broker who does not have a conflict of interest—one who is working for both the borrower and the investor, wants the loan to perform for all parties involved and has a stake in making sure that it does. ▪

ABOUT THE AUTHOR

Carrie holds three executive level roles as president of Ignite Funding, CEO of Preferred Trust Company and COO of iManagement Group Shared Services. Since assuming the role as president, Cook has led the team to fund more than $315 million loans with investor capital. As chief executive officer of Preferred Trust Company, Cook oversees the custody of approximately $250 million in client investments and cash holdings. In addition, Cook also serves as the chief operating officer of iManagement Group since September 2013 specializing in managerial services of investment funds.

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