

How to Handle Owner Financing

Although it's often a worst-case scenario, a seller-financed deal can still help a broker

By **Divina K. Westerfield**, manager, Private Mortgage Association Inc.

MANY MORTGAGE BROKERS may not be aware of how they can make money in a seller-financed scenario. It's often considered a worst-case scenario for the seller, though brokers can help the seller cash out the mortgage note and thus earn a commission.

In today's credit market, owner financing may be the only scenario in some situations.

Let's go through the steps of what brokers must do when forced to cash out a first-lien mortgage note for their clients.

What is owner financing?

Owner financing is when the seller of the property agrees to take back a promissory note and a mortgage or deed of trust from the buyer. The seller's property becomes the security for the repayment of the buyer's obligation. It's an IOU, similar to what any bank would issue.

Typically, only the first-position mortgage note is saleable. Generally, investors will only consider a second-position mortgage note when the total outstanding balance of the first and second mortgage notes is less than 80-percent loan to value (LTV). Often, 100-percent LTV is not possible because most investors want to see the buyer bring something to the deal to mitigate default risk.

The buyer agrees to a 5-percent to 10-percent downpayment. The seller then agrees to take back a first mortgage and sometimes a second mortgage to make the deal work.

The first mortgage will be the mortgage an investor can purchase. The second mortgage will not be purchased but can provide the seller additional income or can be treated like a certificate of deposit, ballooning in a few years. Check with investors to determine the best purchase structure.

If the deal closes properly, the sellers will receive a promissory note and a mortgage or a deed of trust signed by the buyer, in addition to the U.S. Department of Housing and Urban Development (HUD)-1 settlement sheet. If they planned ahead, sellers should also have a title policy because they act as a lender. Investors will need to see each document before closing.

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Some investors also offer what is known as a near-simultaneous closing (NSC), where the mortgage note may be purchased at the closing table in three to 15 days. NSCs typically require at least one payment be made during escrow.

Structuring the deal

Brokers can work with the sellers and buyers to suggest what would work best. But even a seasoned note may require an NSC structure before it can be purchased.

If the note is seasoned and still not saleable, it can be recast to make it more appealing to an investor. For example, a loan that will balloon in six months may be recast to balloon in three years. In some cases, the investor may wish to increase the yield but can compensate the buyer by lowering the number of payments and the overall cost of the loan.

Here are three sample scenarios for how a deal could work.

■ **Full purchase 80-10-10:** With a single-family property type, the buyer puts down 10 percent. The second mortgage has a 10-percent seller carry-back, while the first has an 80-percent seller carry-back, which is purchased at a discount. The seller receives cash from the downpayment, and from the 80-percent first-mortgage note and payments on the second note — or the balloon of the second at a good rate in a few years.

■ **Full purchase 70-25-5:** With a single-family property type, the buyer puts down a 5-percent downpayment. The second mortgage has a 25-percent seller carry-back, while the first has a 70-percent seller carry-back, which is again purchased at a discount. The seller receives cash from the downpayment, and from the 70-percent first-mortgage note and payments on the second — or the balloon of the second at a good rate in a few years.

■ **Partial purchase 95-5:** This time, with a single-family property and 5-percent downpayment, there is a seller carry-back of 95 percent on the first mortgage. The investor purchases part of the note, called a partial, at as much as 65 percent of the property's value. The noteholder keeps the other part. This is helpful when a buyer needs a smaller downpayment. The seller receives cash from the downpayment and purchase of the partial. The seller also keeps the “tail” of the note, which can be sold or kept.

Closing the deal

The great part about working with owner financing is brokers set their own commission. The investors will quote the price they will pay for the seller's note, and brokers subtract commission before giving the offer to the seller.

What happens when sellers agree to sell their note? First, the investor provides a note-purchase agreement with the sellers. The investor will give brokers a side agreement for the commission. The investor also will need the buyer's credit information.

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The investor then orders its own appraisal or broker price opinion. As per the terms of most note-purchase agreements, if the property's appraised value is not what is in the note-purchase agreement, the investor can ask for payment of appraisal costs.

Next, the investor must see a standard note and mortgage reflecting the terms of the agreement. If the investor does not approve the purchase — and if the property sale is contingent on sale of the note — the sellers could refuse to close. Presuming this doesn't occur, the investor's next step is to order the lender's title policy, for which the seller must pay. It is deducted from the quoted price.

If everything is in place, the entire process can be completed in less than one week; typically, it might take 15 to 30 days. **■**