Real Estate Solutions

The Mortgage Note Holder's Handbook

INTRODUCTION

Welcome to our website.

This short PDF handbook was created to assist our private mortgage note holders in better understanding the mortgage notes they own and the process of selling a note if the need should arise. Although the majority of our clients voluntarily carried back paper when selling a property, we also have many who inherited their notes from estates or were forced to take back a note in lieu of a debt. And while there are many benefits of holding high-yield real estate paper, occasionally an individual's circumstances can change, requiring the quick sale of a private note. In such cases, it is always a good idea to understand how the market value of a private note is determined and the various options available to a noteholder when selling.

Mortgage Note Basics

Mortgage notes are created anytime an entity lends money on real estate. In most instances, the lender is an institution such as a bank, savings and loan, or dedicated real estate finance company. Occasionally, individuals will loan money for the purchase of real estate. This is usually to sell a property to an individual that has minimal credit and cannot purchase it through traditional means. All mortgage paper is made up of two components:

- **PROMISSORY NOTE:** This is the promise to repay a certain amount of money and usually includes a rate of interest on the outstanding balance. Real estate promissory notes typically feature a "blended payment" structure whereby each installment is comprised of both interest and principal. Such payment structures are termed "amortized".
- **SECURITY INSTRUMENT:** This is the document that sets out the alternative security for repayment in the even the borrower defaults on the terms of the promissory note. Security instruments are typically structured in one of three forms...
    - Mortgage
    - Deed of Trust
    - Land Contract

MORTGAGE: A *mortgage* is said to *hypothecate* the real estate as security for the loan and in the event the m*ortgagor* (property buyer) fails to pay upon the note, the holder of the note, *mortgagee*, can have the court sell the property to satisfy the loan balance through a process called *judicial foreclose*.

DEED OF TRUST: When a *deed of trust* is the security instrument, the legal title to the property is transferred to a *trustee*, who holds title to the property for the benefit of the lender or *beneficiary*. If foreclosure is required due to non-payment upon the note, the trustee handles the sale of the property to a third party bidder at auction in a *non-judiciary process*. If the third party bidder does not bid enough to cover the loan balance plus interest and fees, the beneficiary will assume a loss on the loan or may bid himself on the property as the highest bidder to retain the property.

LAND CONTRACT: A *land contract* is similar to a *purchase money deed of trust*. Instead of giving title to the property and holding a mortgage or deed of trust secured by a note, the seller enters into a *land contract* with the buyer who promises to pay for the real estate through periodic installments. The property is not deeded to the buyer until payment is made in full.

Regardless of the type of security instrument you have, always maintain your original note and contracts in a safe place such as a safety deposit box. Having original and up to date paperwork is critical to your ability to foreclose on the subject property if it is necessary.

Mortgage Note Valuation

Mortgage note valuation is an important subject not only for those creating and holding notes, but obviously for those investors purchasing notes. As a note holder, you should always stay on top of economic changes and property changes that can adversely affect the security of your loan. Such changes can include:

- Creditworthiness of the mortgagor (payer)
- Deterioration of the property and it's neighborhood
- General economic conditions (statewide and national)
- Policies of the Federal Reserve (are they raising interest rates)
- New state and national legislation detrimental to private notes and note holders
- New tax ramifications regarding taxation of interest and real estate transactions

When a private mortgage note is created, it is most often because the buyer of the property cannot qualify for traditional bank financing. This makes virtual all private mortgage notes *sub-prime paper* and due to this fact, most sellers of property that hold paper will require a significant down payment (such as 20%) to cushion against mortgagor non-payment.

While such a down payment will usually prevent a buyer from simply “walking away” from his/her obligation to pay if things turn bad, other “outside events” can act to so detrimentally affect the value of the property or the note itself as to make holding the note too risky for the average person. This includes:

- **CREDITWORTHINESS OF THE BUYER:** As mention, most buyers requiring owner financing are sub-prime to begin with and have little credit. They do not risk having their credit rating “dinged” if they default. For them, the loss of a job or a criminal event can mean they just walk away from their obligation. It is important to know as much about your mortgagor as possible and stay tuned in to their conditions.
- **PROPERTY DETERIORATION:** Most property owners will attempt to maintain the subject property but some do not. Older properties are often more subject to deterioration than others and if a property becomes run down, it can dramatically reduce the proceeds in the event a foreclosure is necessary.

  Deterioration of the neighborhood in which the property is located is another event that can affect both property and note valuation and it is a good idea for note holders to periodically survey the area in which the property is located and check for significant changes in the “look” of the neighborhood. Be especially “tuned in” to large numbers of run down properties and overgrown landscaping which may signal an unusually high rate of foreclosures in process.
- **GENERAL ECONOMIC CONDITIONS:** Investors (noteholders) must always keep a sharp eye on the economy. Periodic recessions can have a disastrous effect on property valuations as evidenced in the 2006-2012 real estate crash. Though mortgage notes are historically “safe” investments, many noteholders and real estate investors experienced losses of 50% or more during that period.
- **FEDERAL RESERVE POLICIES:** In their mandated job of controlling inflation and deflation in the economy, the Federal Reserve raises and lowers interest rates. This can have a dramatic effect on the ability to finance real estate and also a dramatic effect upon fair market valuation of fixed rate debt. (such as a mortgage note)
- **FEDERAL AND STATE LEGISLATION:** One of the most precarious mine fields in note investing, note holders must be constantly vigilant for legislation that can affect their ability to foreclose on defaulted notes and payment obligations
- **TAX LEGISLATION:** Many note investors and those that offer owner financing do so because of favorable tax treatment upon the sale of the property and the taxes due upon the interest and principal received on the property sale. Changes in taxes can substantially reduce the attractiveness of holding long-term mortgage notes.

Payment Record Keeping

As discussed, it is vitally important to keep your note and all supporting documents in a safe place such as a safe deposit box. Just as important is to keep accurate records of payments and to document any problems experienced in collections. Though these will have little significance if all goes well, they can be extremely important if it comes time to sell your note if a need for immediate cash arises or if foreclosure becomes necessary.

NOTE NEGOTIABILITY

Unlike a deed of trust or mortgage, your actual note is not recorded in county records. In the event of foreclosure or other legal actions, the original note must be produced. Copies will not suffice.

Additionally, notes are negotiable instruments and as such, can be endorsed on the back just as you would endorse a check. So...treat your note just as you would any uncashed check and never leave it just lying around. Keep notes in your home safe or a lockbox at your local bank.

DOCUMENTING MORTGAGOR PAYMENTS

Always maintain an accurate ledger of payments showing the date each payment was received as well as a running total of principal and interest. This is very easy to do using a simple amortization schedule and if you do not have one, you can request one from us by simply providing us with your note details. Records of timely payments by the mortgagor are very important should you someday find you need to sell your mortgage note. You should either make a copy of each check or payment as it is remitted or print out monthly checking account statements showing deposits with an image of checks received.

ADDRESSING LATE PAYMENTS

If you receive a late payment upon your note, you should always contact the mortgagor to find out why. This is in the mortgagor's best interest as well as yours as in many cases, the mortgagor is trying to rebuild credit so he/she can ultimately obtain more traditional financing. In the event that you someday need to sell your note, patterns of late payments will definitely reduce your note's resale value. Institutional buyers will want to know exactly why payments were late and you should have an acceptable reason.

ADDRESSING DELINQUENT PAYMENTS

If a payment from a mortgagor is over 30 days in arrears it is considered *delinquent* and although you likely talked to the payer when the payment was simply late, *delinquent* payments mean you need to take the conversation to the next level. The worst thing you can do is begin foreclosure proceedings so long as there are avenues that exist to remedy the situation.

If you are forced into a foreclosure, understand the process can take many months and sometimes even years. This is time where you will generate no income from the note, likely be responsible for attorney's fees, and also experience a time when the property owner will take little or no care of the property, decreasing it's value quickly. In short, it will always be more advantageous to find remedies other than foreclosure. If it becomes necessary, then so be it. But make certain you exhaust all other legal options.

MAKING UP DELINQUENT PAYMENTS

The best option is naturally to have your mortgagor make up the delinquent payments. This can sometimes be a viable remedy if the payer simply lost a job but quickly replaced it with another. Seldom will they be able to make up payments in a lump sum, but may be able to make double payments until they bring the balance current.

If the payer resolves his/her income problems and can begin making payments again but finds making up the payments in arrears impossible, this will give you a perfect opportunity to *restructure* the note. While the original interest rate was likely an accommodation to get the property sold, that will not be the case if the note is restructured. Restructuring will give you the opportunity to raise the interest rate slightly which will, over time, make up for the loss of income experienced during the delinquency. It may also be a good time to build in a *balloon payment* if wanted.

OFFERING "KEY MONEY"

If you find there is no other option than foreclosure for recovering the property, one way to avoid a *judicial* or no*n-judicial foreclosure* is through an offer of "key money". Just like it sounds, key money is a sum of money the note holder will offer the mortgagor for the keys to the house along with a *deed in lieu of foreclosure*. This strategy eliminates the need for a costly proceeding, provides the mortgagor with some cash to move and rent another residence while he or she gets their life back in order, and avoids damage and impairments to the property that can occur during a messy legal process.

It is simple to understand that a noteholder can easily suffer a $10,000 loss or more in delinquent payments and attorney's fees while going through a foreclosure. Offering a defaulted mortgagor a fraction of that amount to execute a *deed in lieu* and to simply turn over the keys saves much time and money and allows you to quickly make repairs to the home if necessary and place it back on the market.

Selling Your Note

Private real estate notes are negotiable instruments and as such, can be sold at any time. What is actually being sold when you sell your note is it's *income stream* and the value of that *income stream* to a buyer is based upon many criteria such as...

- **INTEREST RATE:** A comparative value based upon other investment options in the marketplace. For example, compared to bank CDs. Notes with higher fixed interest rates will have a higher resale value than those with lower interest rates, all other things being equal.
- **DOWN PAYMENT:** Notes that were created with a larger down payment will have a great value that those with little or no down payment. The mortgagor is less likely to simply walk away from the obligation.
- **LOCATION:** Notes based upon properties in locations where property values are on the rise will have greater value than those on properties located in neighborhoods on the decline.
- **MATURITY:** Notes with shorter maturities or notes with balloon payments will usually have a greater resale value than those amortized for 25 years or longer.
- **SEASONED NOTES:** Notes where the noteholder has been receiving timely monthly payments for a year or longer will typically have a greater resale value than those where payments have only been received for a few short months.
- **TIMELY PAYMENTS:** Notes that exhibit a history of payments made on-time with no late or delinquent payments will naturally have a greater resale value than those with a history of late payments.

In viewing the list above, you can also understand the importance of original note structure if you believe you will be selling the note in the future. While an initial low interest rate and long amortization will certainly help you to sell a property, those same features will make your note considerably less valuable if you are forced to sell. When originally structuring your note, you should consider the features that can affect your note's value if you are forced to sell. Building in features like balloons and interest adjustments over time can help to drive your property buyers to repair their credit and seek out lower rates and financing options as time goes on and their credit improves. These same features can make your note considerably more valuable if it comes time to sell.

Note Selling Options

When selling your note, you will find you have many options based upon your needs. For example, do you need a complete lump sum cash out of your note's balance or do you simply need a fixed amount of cash for a specific reason and would like to retain the balance of your note. There are literally dozens of options and combinations regarding note sales but the most common are:

- **FULL SALE:** With this option, the institutional buyer will purchase all remaining payments including a balloon if present
- **STANDARD PARTIAL SALE:** This is the sale of a fixed number of future payments for a lump sum of cash now. Once the fixed payments are received, the note reverts back to the seller who will then receive the remaining balance of payments
- **SPLIT PAYMENT PARTIAL SALE:** This unique options allows the noteholder to sell a percentage of a fixed number of future payments. For example, a noteholder may sell 50% of the next 48 monthly payments, still receiving half the monthly income over the next 48 months and then receiving 100% of all future payment thereafter
- **BALLOON CASH OUT:** For notes containing a future balloon payment, this option allows the note holder to continue to receive all monthly payments and an immediate discounted lump sum of cash for balloon payment due in the future

ABOUT DISCOUNTING

In almost all instances, the sales price of a note to an institutional buyer will involve *discounting*, which reflects the *time value of money*. On rare occasions, a note may be purchased at face value. This can occur in notes structured with short maturities, such as 10 years and less, that also feature high interest rates of 12% and more and have a history of timely payments, significant down payment, and represent high quality real estate. The vast majority of note sales, however, will be *discounted* to reflect current interest rates in the marketplace and identifiable and perceived risks to the buyer.

It is relatively easy to understand why payments are discounted. For example, purchasing a payment due tomorrow for $800 is worth virtually $800 because the buyer will only need to wait one (1) day to receive repayment, whereas the same $800 payment due one year from today must be discounted, if purchased today, to reflect the one year wait for repayment.

The interest rate used to calculate the discount for payments due months and years into the future, reflects the risks being assumed by the note buyer over such a long period of time as well as the note buyer's cost of funds. In the example below, we will use a brand new note to illustrate for simplicity:

Example:

Jim sells his home for $100,000 and receives a $20,000 down payment. He agrees to finance the balance and creates a carry-back note of $80,000 with an interest rate of 10% due in 25 years. The note's monthly amortized payment is $726.96. He immediately decides to sell the note to Bill, a note buyer.

Bill's cost of funds is 10% and he wants a 5% profit. Given the property securing the note meets his other buying parameters and the mortgagor's credit is acceptable, Bill will bid to purchase this note at a 15% discount or a total purchase price of $56,756.97.

The above example illustrates two very important relevant points or characteristics of private note transactions...

1. When selling real estate and agreeing to hold paper, you should get top dollar (or above top dollar) due to your valuable, private financing accommodation to the buyer. Property appraisals are irrelevant when providing owner financing.
2. Creating a note with a low interest rate and long maturity corresponds to a significantly discounted price if you are required to sell your note in the future. Be aware of this important fact when initially creating any private note.

POWERFUL PARTIALS

Partials are by far the most popular type of note sale primarily due to the significantly smaller discounts. They are used when only a partial sale of a note is required to meet current financial needs and obligations.

Example:

Tony was given a new note by his father to assist in paying for his college tuition. In giving Tony the note, it was understood that he will enjoy the monthly income as it is paid and then sell a portion of the note through a partial sale to meet lump sum tuition obligations as required. It is identical to the note in the previous example with an $80,000 balance, a 10% interest rate, and amortized for 25 years with a payment of $726.96. This note, however, was also structured with a ten (10) year balloon payment.

To assist with paying his first year's tuition, Tony will need $8,000 and to get the funds, he contacts a note buyer recommended by his father. The note buyer was already familiar with the note as he coached Tony's father on structure when setting it up.

Because this note was created with a 10 year balloon, the default risk is considerably less to the note buyer and he will bid this note at a 13% discount rather than 15%.

To get the $8,000 required for the first year's tuition, Tony will sell a series of the monthly payments of $726.96. Each payment will be discounted by 13% based on the note buyer's cost of funds and the note buyer calculates he will purchase 12 of the upcoming future payments which, at a discounted rate of 13%, will provide Tony with $8,139.08 to pay this year's tuition. Once the 12 payments are collected, the note will revert back to Tony who will again sell a portion for the upcoming year's tuition using an identical transaction.

With the need to sell 12 payments each year for a total of 48 payments to assist him through the four years of college, Tony will still collect the balance of the payments (72) until the balloon payment is due in the 10th year, at which time he will collect the balloon payment of $67,649.09.

As you can see, *partials* offer a powerful alternative to a 100% lump sum cash out of a note in situations where they can be utilized. Structuring a note with a balloon payment additionally tends to buffer the deep discounts experienced on long term notes created without this important feature.

Get a Note Quotation

If you are contemplating selling your private mortgage note, the first step is always to request a FREE and complementary note purchase quotation. Our contract buyers are recognized experts in the industry and once we have received an overview of your note and capital needs, we can provide you with not only a *top dollar quotation* for a lump sum cash out of your private mortgage note, but also a variety of money saving and creative purchase options based upon your time requirements and capital needs.

To receive a complimentary quotation, simply visit our website and from our mortgage notes page, click the link for a FREE quotation. One of our courteous contract buyers will typically be in contact with you within 24 hours to begin the FREE quotation process. Once you contact us, you can be just a few days away from receiving the lump sum capital you need and deserve.