What Every Mortgage Investor Should Know

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Chapter One

INTRODUCTION

If you're an investor in mortgages, trust deeds or land contracts, or are considering taking advantage of the high yields this kind of investment offers, you've probably already heard horror stories about ill-informed investors who have lost substantial sums of money. If you haven't heard any horror stories, you should ask mortgage brokers, your state securities division personnel or experienced title officers, as there are such stories in nearly every community. Helping you to avoid participating personally in such a story is the aim of this book.

What makes for such horror stories? Usually ignorance---not doing the required homework---and greed account for mortgage investments going sideways.

The purpose of this publication is to give you, the prospective investor, the tools to properly evaluate your investment.

Before starting, however, there are a few items which need to be addressed.

First, for the sake of brevity and except where necessary to provide distinction between the various documents, we shall call this kind of investment “mortgage investment,” even though the term will encompass investments in mortgages, trust deeds, land sale contracts or contracts for deeds. Also, this publication addresses the purchase of entire mortgage investments only, as opposed to participation or partial interests in the mortgage or its cash flows. Before purchasing any partial interest in a mortgage investment, please read the section in Chapter 12 specifically dealing with this topic. Also, this publication is intended to focus on investing in first mortgages, trust deeds and contracts, as opposed to seconds, thirds, and so forth. Chapter 12 contains some specifics to watch for if you intend to invest in mortgages in other than first priority position.

Second, while this publication is intended to give you the tools needed to properly evaluate a prospective mortgage investment, it is simply impossible to cover every circumstance or potential way for you to lose money on a given transaction. As discussed later, it is recommended that you consult a qualified attorney who is knowledgeable in real estate and securities law for each investment you make. Use this publication as a tool for identifying possible areas of concern, but also use your common sense and your attorney to evaluate the details of your particular prospective mortgage investment.

Third, make contact with your state's securities division. In most cases a call to the agency responsible for regulating professional real estate activity in the state will assist you in finding the particular division responsible for mortgage securities activities. Ask the securities division about the parties with whom you are dealing, whether they are properly licensed, and ask if any complaints against them have been registered with the state. When one sells a promise to perform (such as a mortgage broker selling a borrower's promise to repay a debt), a security is usually created and is subject to government regulation. It is your responsibility to determine that the parties involved in the creation and sale of your prospective mortgage investment are dealing on the up-and-up.

Fourth, before you consider the merits of a particular mortgage investment's yield, know just how suited to this kind of investment you are. Investor suitability is not merely a financial consideration. Issues such as your age, your ability to deal with the possible consequences of foreclosing, owning, operating and selling real estate, your overall liquidity and your tax situation are the kinds of considerations you need to address before evaluating the merits of a given mortgage investment.

Fifth, each state and municipality may have its own particular set of regulations pertaining to mortgage investment. The information contained in this publication is fairly generic and is likely to be true as to your area; however, it is absolutely critical that you understand that it is your responsibility to apply this information to the regulations and customs particular to your area. Working with a competent real estate and securities attorney is a best first step. Using the information contained in this publication without checking on any local mortgage investment particulars is definitely not recommended.

If you do your homework properly and the real estate market is favorable, it's likely that an interruption in your receipt of cash flow and the potential loss of your time in dealing with a problem mortgage investment will be the only major disappointments you'll experience. If the yield you receive adequately compensates you for these and other potential disappointments, then the mortgage investment probably deserves your consideration.

As in any other business activity, it is always possible for you to be defrauded. The best defenses for any prudent investor involve doing the required homework diligently before investing. In this respect mortgage investing is no different from any other kind of investing you may be considering; and mortgage investing is almost singular in the degree of control the investor has over what he ultimately decides to purchase and the conditions under which he decides to invest.

While it's true that there are many ways to lose money in mortgage investments, it's also true that banks, finance companies, savings and loan associations, credit unions, insurance companies, public and private trusts and pension funds, governments and private individuals have successfully invested in real estate-secured paper for decades. A good mortgage investment can offer incomparably high returns; is usually a relatively local investment that often puts its proceeds back into the local community's economy; offers a certain degree of personal satisfaction and involvement for the investor; and offers a much larger degree of investor control than does, for example, an investment in a large, corporate debenture.

Invest, but do your homework first. Use the mortgage investment checklist contained in this publication, your attorney's advice and your common sense, and you're on your way toward a successful mortgage investment!

EDITOR’S NOTE: This was originally written in 1988, and there have been significant changes in the industry and the economy since then. Some examples of such changes are the enactment of the Home Ownership and Equity Protection Act of 1994, a national fixation on rights to privacy in obtaining personal information, technological advancements in the collection and dissemination of debt and credit information, a dramatic rise in the general value of real estate and the amounts of money typically involved with mortgage investing, and the rise in the number of bankruptcy filings and the ease and cultural acceptance of such filings. The Wall Street Reform and Consumer Protection Act of 2010 (commonly known as the Dodd-Frank Act) drastically changed

and complicated the landscape for lending, particularly in cases where the proceeds of the loan are used primarily for personal or family purposes and where the security given for the loan is the personal residence of the borrower. These and other significant changes occurring since the writing of the original text of this publication are <u>not</u> taken into consideration in what follows. These changes amplify and underscore the need to have professional and competent mortgage investment consultation <u>before</u> you invest.

Chapter Two

THE FINANCIAL OBLIGATION

EVIDENCE OF THE DEBT

Most mortgage investments consist of two parts: a promissory note and a security instrument.

The promissory note is the evidence of the debt. Basically a promissory note is the borrower's (payor's) promise to repay a stated debt. The note will usually contain provisions for the collection of attorney fees and other collection costs if the borrower defaults on his promise. The note will spell out the terms of repayment, including the interest rate, the original principal sum to be repaid, the repayment period, the amount of the periodic payments, and the date at which the entire balance is to be paid in full. Possession of the original promissory note is absolutely essential to any investor, as without the original note it is simply impossible to rely on any guarantee being made by the party from whom you may be purchasing the note that the note has not been sold or pledged for security purposes previously.

Knowing that the parties who signed the promissory note had legal capacity is important. Minors or those who might be have been under the care of a conservator are two examples of persons lacking proper legal capacity to sign a promissory note.

Authority to sign is another issue. If the borrower was a corporation, did the person who executed the note have proper authority? If the borrower was a partnership, did the person who executed the promissory note have proper authority?

The issues of capacity and authority can usually be answered for you by the title company. Issues of this sort are of particular interest to title companies, as some major title company losses come from the improper capacity or authority of persons executing the documents affecting the title they are insuring.

Always ask for a statement regarding possible defenses from the party from whom you are purchasing your mortgage investment. If the promissory note has a potential defense to your demand for payment, you want to know about it now. As a practical matter, the only thing you're after here is to know what, if anything, might be wrong with the investment.

Guarantees will be discussed later in more detail, but at this point you should approach every mortgage investment as though no guarantee of any nature is included except the property pledged as security for this investment itself. Relying on other people's promises is usually a disappointing process, and in many cases the guarantees made are not reliable anyway.

When a new mortgage investment is created, the borrower will simply sign the original promissory note in favor of the investor. However, not all mortgage investments are initially set up in this manner, and the mortgage investor buys the investment from the party who originally received the benefit of owning the promissory note and security instrument.

Whenever a negotiable instrument, such as a promissory note, is transferred from one party to another, it is transferred by means of an endorsement. Endorsing the note is typically done by having the transferring party (seller of the note) writing “pay to the order of (the name of the receiving party---buyer of the note)” on the reverse side of the original note, then signing his name as it appears in the note.

There are two kinds of endorsements: with recourse and without recourse. If there is no specification as to recourse, then typically the note is being endorsed WITH recourse. What recourse means is that the person endorsing the note has made a passive guarantee of the terms of the note and is in the line of liability for performance of the terms of the note. It is only when the endorsement is made without recourse that the endorser becomes removed from the line of potential liability under the note. This is an important point! If you don't want to become liable for performance of a note, only endorse a note without recourse. If you want the person from whom you're receiving the note to guarantee the note's performance, make sure the note is endorsed by him with recourse.

As mentioned later in Chapter Eight, mortgage brokers in certain license categories are specifically prohibited by the government from making guarantees, including guarantees created by endorsing promissory notes with recourse. In such cases you will not be able to obtain any form of guarantee from the offering mortgage broker.

Always make sure that you receive the original promissory note when you purchase any real estate-secured obligation. And when you are purchasing an obligation that has been sold before, i.e., the original lender has sold the note and mortgage before your purchase of it, then it is essential that you verify that the promissory note has been properly endorsed by the parties who owned it previously. Title companies are only concerned with what is of public record, as that's all they are being paid to insure. A promissory note is not generally recorded and is not something you may expect a title company to review. The reason that it's important to verify that all previous owners of the note have properly endorsed the back of the note is simple: if one owner didn't properly endorse his interest in the note to the next purchaser of the note, then the chain of ownership is incomplete, and it'll be more difficult for you to prove in a legal proceeding that you have legal right to collect the debt. Your rights under the promissory note are only as good as the rights of the person from whom you're purchasing the note; and if he never really received a proper endorsement from the person from whom he purchased the note, then you've exposed yourself to a potential mess in establishing your rights to collect from the borrower. It's a simple situation to avoid before you purchase the note.

If part of the security for the note you're purchasing is personal property, then it's probably necessary that you have a separate obligation, usually called a security agreement, in which the borrower pledges specific items of personal property as security for repayment of the debt. The security agreement is to personal property what a mortgage is to real property. In order not to complicate your case in collecting a debt secured by personal property, it is necessary to have a valid security agreement and personal property security interest filing with the county and/or state in which the personal property is located. In most areas a procedure defined by the Uniform Commercial Code is followed, and there's more about this procedure in the next chapter. This area is not typically part of mortgage investing, so we won't dwell on the point. The best idea in such cases is to consult your attorney for advice on the subject.

Chapter Three

SECURITY INSTRUMENTS

There are three general types of instruments which give the investor rights to real property if the borrower defaults.

Mortgage

The first type of security instrument is a mortgage. Under a mortgage, the borrower is called the mortgagor and the lender is called the mortgagee. The mortgage typically provides that the borrower keep the property adequately insured, that he pay property taxes before they become delinquent, that the property not be destroyed or removed, and that the property be maintained in good repair.

As a practical matter, it has long been established legally that the conveying of the property to the lender can only be perfected by means of the borrower voluntarily deeding the property to the lender or the lender foreclosing the borrower's interest in the property. Foreclosure only takes place under circumstances in which there has been some kind of default by the borrower in performance under the terms of the promissory note or the mortgage.

Foreclosure is a term to describe the process by which the borrower's interest is removed from the property and the lender usually receives title to the property. In the case of a mortgage, foreclosure is generally accomplished by a judicial proceeding at the intermediate court level (the courts of equity, such as circuit or superior court) in the county in which the real property is located.

The lender's foreclosure suit is usually based on the borrower's non-payment of the debt, and so the case is as simple as the court resolving the question of whether the payments were made as agreed. Although there may be other reasons for foreclosure, usually the foreclosure stems from a lack of proper payments. In the foreclosure suit all events of default, including non-payment of property taxes, lack of provision of fire insurance, etc., are included in the complaint.

Assuming that the court finds in favor of the lender, the court orders that the county sheriff sell the property to the highest bidder and remit the proceeds from the sale to the lender for payment of the borrower's obligation. The sale is advertised for several weeks in a local newspaper of general circulation.

If there is a shortfall of funds from the sale, e.g., if the sale doesn't produce enough money to cover the borrower's obligation to the lender, then the lender may be entitled to a deficiency judgment, which it is possible to use in levying against the borrower's other assets, such as bank accounts, other real property and wages. Deficiency judgments are limited to only certain circumstances, and you'll need to check with your attorney for the exact prospects to obtain one.

Sometimes, of course, the amount the successful bidder offers at the sale exceeds the amount owed to the foreclosing mortgage investor. In these cases it is typical for a particular order to be followed, this order being dictated by the state's statutes governing foreclosure actions. Usually proceeds from the sale flow first to the foreclosing party, then to the party with the next oldest secured interest in the property, and then down the line of priority through the various lenders. If all the lenders are satisfied, the balance would belong to the borrower.

In a judicial foreclosure action, as is usually the case in a mortgage foreclosure, the lender typically accelerates the entire balance due. Acceleration means that the entire principal balance plus accrued interest are called immediately due and payable in full, even though the debt would have taken years and years to pay off in full had the original payment schedule been observed.

Frequently the lender works out to be the successful (highest) bidder at the sheriff's sale, as the lender's bid is usually the total of all he has coming from the borrower plus the costs of foreclosure. There are many strategies for bidding at the sheriff's sale, and your attorney would advise you as to your best strategy should you find yourself in such a situation.

The successful bidder at the sheriff's sale receives a sheriff's certificate of title to the property. However, that certificate is subject to certain rights of redemption the borrower has to pay off the total debt. The redemption period varies from state to state, but the average is six to twelve months. During the redemption period the investor usually has possession of the property. At the end of the redemption period, and providing that the borrower doesn't redeem the property, the holder of the sheriff's certificate receives a sheriff's deed to the property and is officially the owner and may do whatever he wants with the property.

Possession during the period of redemption can be a tricky issue. Although the investor actually is the legal owner of the property, he knows that the borrower still has a right of redemption. It usually would be foolish for the investor to do anything in the way of upgrading the property, or anything other than merely protect his security interest in it, as getting his money out of the property is complicated by the borrower's potential interest until any right of redemption has expired. If the borrower redeems the property, in most states the investor is entitled to receive compensation in the form of interest, usually at a fairly low rate, for the period between the sheriff's sale and the date the borrower redeems the property. The investor's ability to recover other costs experienced during the redemption period is not as clearly defined.

Under a mortgage, the entire judicial foreclosure process usually takes a year or longer.

Trust Deed

A trust deed is similar to a mortgage in many ways. First, it establishes a lender's interest in a specific property. Second, a trust deed usually may be foreclosed like a mortgage, e.g., judicially. Third, it is created as a method to back the borrower's promise to repay a specific debt to the lender, and evidence of that debt is a promissory note executed by the borrower.

Under a trust deed the borrower, known as the trustor or grantor, passes conditional title to a third party, known as the trustee. The borrower grants the trustee, usually an attorney or title company, the power of selling his property if the terms of the promissory note and trust deed are not fulfilled as agreed. The trustee works on the behalf of the lender, known as the beneficiary under a trust deed.

Although a trust deed may be foreclosed judicially, it has the added feature that it may be foreclosed non-judicially. In a non-judicial foreclosure, a default is declared, typically a notice of default and election to sell is served on the borrower and the parties of interest in the property, and the notice is filed in the county in which the property is located.

In the notice, a sale date is specified. A trustee's sale is similar to a sheriff's sale in that a time and place for the sale are stated and the sale is advertised well in advance in a local newspaper of general circulation. The property typically may be sold anytime after 120 days from the date of the filing of the notice of default.

In a non-judicial foreclosure the lender may not accelerate the entire balance, as the borrower is typically granted to within a few days of the sale date to bring the loan current, including accrued interest, late charges, and foreclosure costs. If he does bring the loan current, the loan goes on as though no default had ever occurred. If the borrower doesn't bring the account current, the lender in effect accelerates the entire balance of the loan at the trustee's sale.

The successful bidder at the sale receives a trustee's deed to the property and owns the property outright. The borrower typically has no rights of redemption. There is no deficiency judgment possible under a nonjudicial foreclosure.

A non-judicial foreclosure is usually a more simple, speedy and inexpensive manner of foreclosing. Choosing the best method of foreclosure is a matter for you and your attorney to determine, and your choice will largely depend upon the circumstances of your particular investment.

Contracts of Sale

Also known as contracts for deeds, land sale contracts or simply contracts, contracts of sale are a bi-lateral agreement between a buyer and a seller. As you might expect, the buyer agrees to buy a particular property, and the seller agrees to sell that property. The contract specifies the terms of sale.

Under a contract of sale, the seller, or vendor, agrees to execute a deed to the buyer, or vendee. The deed is to be delivered to the buyer when the contract has been fulfilled completely. Usually the contract is fulfilled when the last payment has been made.

While the contract exists, the seller continues to hold fee title to the real property, while the buyer holds equitable title. The fee title is transferred to the buyer when he records the deed he receives upon having paid the contract in full.

It is impractical for the seller to be at all times poised to give the buyer his deed, and it is imprudent for the buyer to make payments for years under the contract not being absolutely sure that the seller has a deed ready for him when the last payment has been made. To address these problems, a collection escrow is established, and the agent is instructed in writing by both parties to hold the executed but undelivered deed from the seller to the buyer until the buyer has made all payments as agreed. The collection escrow agent keeps track of the payments and keeps the deed in safe deposit.

Under a contract of sale, foreclosure is usually a judicial matter, although in some areas and under some circumstances it is possible to pursue a non-judicial forfeiture. Contractual disputes are typically heard before courts of equity, so the judicial foreclosure process is much like that of a mortgage. The major difference between a mortgage foreclosure and a contract of sale foreclosure is that the period of redemption is fixed by the court in the foreclosure of a contract of sale. That period may vary from one month to a year or more.

There is almost nothing standard in a contract of sale. If you are interested in purchasing contracts of sale, it is critical that you have your attorney review them in terms of their collectibility, legality and enforceability.

Security Agreements

When personal property is being pledged to secure a borrower's payments evidenced by his execution of a promissory note, the instrument generally used is a security agreement. A security agreement and a financing statement, which perfects the security agreement's performance, identify the personal property being pledged to the exclusion of any other personal property. The security agreement identifies the specific debt the financing statement is being executed to secure, and it gives the lender a potential interest in the pledged personal property if the borrower defaults on performance under the promissory note and security agreement.

Most areas observe a filing procedure established under the Uniform Commercial Code, in which a more or less standard form is filed with a state-level agency. The filing of this financing statement establishes the lender's priority in interest to the pledged personal property. Most states handle automobiles, boats and aircraft separately. Financing statements and their filings usually pertain to other items of personal property.

If you're interested in taking personal property as security for a borrower's obligation to repay a debt, it is important for you to retain competent legal counsel to guide you through the process.

Chapter Four

TITLE INSURANCE

Title insurance is one of the most unusual businesses in the world. Other than outright title fraud, about the only thing title companies insure is their ability to accurately read the public records. So, in a sense, the only risk they're covering is the risk that they themselves might create. The business is also largely misunderstood: the seller pays for the insurance but doesn't receive it; the buyer gets it but doesn't understand it; and the realtor who orders it is more concerned with the escrow services provided by the title company than the title insurance itself. However, title companies provide services which are indispensable to a mortgage investor.

First, title insurance identifies the legal owner of the real property; any liens, taxes or judgments affecting the property and the priority of such items in terms of recording; any situation involving a party whose personal judgments or liens might attach to the real property; and any notices filed in the county where the property is located and which affect this property.

Second, title companies possess a wealth of information in the way of maps, document archives, expertise in the area of title problems and title theory.

And, third, title companies work in conjunction with escrow companies to help successfully close and collect real estate-secured debts.

There are many different types of title reports and policies offered. For our purposes, the report ordered is usually called a preliminary title report or conditional commitment for title insurance. It isn't a policy per se, and only becomes a policy when the premium is paid and you select the amount of coverage you want.

A standard mortgagee's policy insures that the status of the subject property's title is as shown on the policy; i.e., the owner is as stated and the liens affecting the property are as stated. The policy typically provides coverage in the amount of your investment.

The most extensive form of coverage is provided by an ALTA policy. An ALTA (American Land Title Association) policy provides coverage for such things as encroachments (when one property's boundaries are not observed by another), material suppliers' and laborers' claims arising from construction on the property, the improvements not being located on the property in question, etc.; this policy costs about one-half again as much as standard coverage and simply may not be available under some circumstances.

If you deal in contracts of sale, you'll order owner policies, as you'll be passing into title yourself when you buy the contract.

The party named as insured appears in the policy itself, and you should make sure that you are the named insured. Under certain circumstances, there may be an endorsement to the original title policy, and the endorsement will actually name you as the party insured. Always make sure that you end up in possession of the original policy naming you as the party insured or with the original title policy and an original endorsement from the carrier naming you as the new insured.

Priority is everything when it comes to mortgage investments. Priority is typically established at the time a given lien is executed and recorded at the office of the recorder at the county courthouse. If a mortgage is recorded at

1:02 PM on June 18, 1988, and another is recorded at 1:03 PM the same day, the mortgage recorded at 1:02 is superior in priority to the mortgage recorded one minute later.

If a mortgage that has “FIRST MORTGAGE” printed on the top of it is executed and recorded after another mortgage on the same property, then the mortgage with the “FIRST MORTGAGE” label is really a second mortgage.

Recording is the standard method used to establish priority in property. However, the fact that an interest in property is not recorded doesn't necessarily mean that the interest is invalid or unable to be perfected. If you become aware of an unrecorded interest in the property you're examining, you should treat that interest as you would any recorded interest in the property and understand that your interest in the property may well be inferior in terms of priority.

In any title report the liens affecting the property will be listed in the order of their proper priority in time. If your mortgage appears before another mortgage, you would appear to have a superior mortgage.

Any decisions you make about a given mortgage investment simply must be based upon a title company's preliminary title report and its guarantee to provide you with a title insurance policy in the amount of your investment.

Title insurance premiums are a cost of doing business, and the risk of doing business without adequate title work is inordinately high.

If the mortgage you're purchasing was insured previously, you may be able to purchase a less expensive endorsement to the original policy. Ask your title company or attorney for details.

Always know the status of title to the property you're evaluating. The logic here is simple: one day you may own this property, and you should know what it is you may be buying.

Chapter Five

PROPERTY VALUE CERTIFICATION

What is a property worth? The best answer to this question: what someone will pay for it. The problem is that it's difficult to determine in advance of the event (1) just how much a willing buyer will pay for the property; (2) how long it will take you to find the buyer; and (3) under what terms the buyer may be willing to pay you. And, of course, all of these factors and more can greatly affect the value of any property.

There are three distinct methods of evaluating property value.

Income Approach

In the income approach, the income the property is anticipated to produce is analyzed as net cash flow to the owner and multiplied by capitalization rates consistent with other real estate investments. There are other methods to analyze income, such as using gross rent multipliers, but all the income approaches share the feature that they determine the property's value by means of analyzing the property's relative income.

Replacement Approach

The replacement approach establishes the cost of replacing the improvements with similar-quality elements, then subtracts from this sum the amount of depreciation evident. Depreciation can be in many forms, including physical (such as deferred maintenance), functional (such as an inconvenient floor plan) or economic (such as a blighted neighborhood). From the depreciated cost of replacing the improvements is added the comparative value of the land under the improvements. This approach is typically used in fire insurance valuation situations and for properties like churches, which don't really have a cash flow per se and for which there are few comparable sales.

Market (Sales) Approach

The third approach is the sales or market approach. Here the task is to compare the attributes of the subject property to the attributes and terms of sale of similar local properties which have sold recently. Several comparable properties are analyzed, and the various differences are weighted relative to price. In cases where numerous comparable sales are available, the market approach generally produces a fairly tight distribution of values. Where few comparable sales are available, the idea of using the market approach becomes less attractive. But finding few, if any, comparable sales in itself tells you something about the property you're analyzing.

Something akin to the market approach is a CMA (Competitive Market Analysis). Realtors frequently prepare such reports to determine a fair asking price at which they might list a given property for sale. The key difference between a CMA and a market approach appraisal is that the CMA uses and frequently concentrates on properties not yet sold, but just on the market. The purpose of a CMA is different from an appraisal made for mortgage investment purposes, and you should recognize the difference.

In mortgage investing the reason you're concerned about value is that if everything goes haywire with your investment, you may well be stuck with the property, and you want to know that you can quickly sell the property for at least the amount you have invested, plus interest and your costs. What it costs to replace the property or what kind of cash flow it produces, then, are probably issues of secondary importance to you. The primary issue for you: how soon you can sell the property, what terms may you expect to receive, and for how much may you reasonably be able to sell your property. All of these points are typically addressed in appraisals based on the market approach.

In a typical real estate appraisal, the appraiser considers all three approaches for the property, then selects just one of the three for final value determination. He doesn't average the results of each of the three approaches to value.

There are many kinds of appraisers. The highest designation an appraiser may obtain is MAI (Master of the Appraisal Institute), and if you deal with an MAI appraiser you can count on fees about triple the non-MAI going rate. SRA (Society of Real Estate Appraisers) appraisers are more commonly used and are less expensive than MAI appraisers. Not all qualified real estate appraisers are designated members of professional societies; however, in most states professional appraisal activity is regulated and all appraisers must be licensed.

There are many different types of appraisals, too, as the following examples show.

The county tax assessors in most states are charged with the duty to appraise each property in the county for tax assessment purposes. This type of appraisal is more commonly and correctly referred to as an assessment, rather than an appraisal. Using county tax assessor values can be very misleading, and you're well advised to bolster the assessor's opinion of value with additional data.

The most common type of appraisal is done on a FNMA (Federal National Mortgage Association; the acronym is pronounced “Fannie Mae”) form. The forms are consistent with current appraisal standards and underwriting requirements found in the mortgage secondary market, where conventional and government insured and guaranteed loans are resold to institutional investors, such as large life insurance companies, pension plans, etc.. There's a sample FNMA appraisal form in Page 91. This kind of appraisal costs in the neighborhood of $200 for a standard, single family, local and typical home.

Narrative appraisal reports contain the same information FNMA appraisal forms contain, but they're thicker and more impressive to look at and handle. The narrative appraisal form can impress a prospective property buyer, but it also requires of a diligent investor that he read the report cover to cover, as non-standard items and disclosures are more easily hidden in a narrative report than they are in a FNMA report. The appraiser's fee for a narrative report is about the same as for a FNMA report.

A CRV (Certificate of Reasonable Value) is issued by staff appraisers for certain government insured or guaranteed loans. The form itself is not as detailed as a FNMA form and is far less common in the case of private mortgage investment.

All appraisals contain statements of limiting conditions. Typically an appraiser will state that he has no present or contemplated future interest in the property and that he has personally inspected the property. He will limit his liability as to undisclosed or hidden aspects of the property, including zoning problems, code violations, and title defects which may affect marketability.

One major presumption that is incorrectly made by many investors is that when an appraiser says a property is worth $50,000 he means $50,000 cash right now. There are two problems with this assumption. First, the appraiser means cash OR terms typical of the market. “Terms typical of the market” means terms that are likely to be found in the sales of similar properties, which, of course, doesn't necessarily mean cash at all. In many cases “terms typical of the market” means a sale with ten percent down and the balance carried back by the seller for the next twenty years at eight percent interest. Second, the appraiser means that you're likely to get $50,000 cash (or terms typical of the market) given ample marketing time. Ample, needless to say, is a term it's difficult to pin down and means only that you wait the amount of time other, similar properties had to wait to be sold.

Common Sense and Value

No matter what an appraiser may tell you about value, use your own common sense before investing. Would YOU pay that much for the property? Would any reasonably informed person pay that much for the property?

One rule of thumb to keep in mind is that replacement cost ALWAYS sets the upper limit on the value of anything. That is, if at a lower price you can replace this property with a similar or superior property, this property can't be worth more than the other.

Look around. What can your money buy in this marketplace? Ask questions of realtors and others in the business. If there's something you should know about this property, it's certainly best that you find out about it before you invest.

Relying on appraisers and others is fine, but nothing is meant to replace your common sense. If this investment doesn't pass the common sense test, then pass on this one and go to another.

Loan-To-Value Ratio

After you've determined the value of the property, the next consideration is the amount of money you are willing to have invested in that property. The term “loan-to-value ratio” is the way most lenders look at this consideration. A maximum loan-to-value ratio is part of almost every lender's underwriting policy.

Maximum acceptable loan-to-value ratios for most credit lenders, such as banks, savings and loan associations, credit unions and government lenders run as high as 90+ percent; e.g., the lender would be willing to advance up to $45,000 or more against the value of a $50,000 property, provided that the borrower has good credit.

For private mortgage investors a maximum loan-to-value ratio should be more in the 50 to 60 percent range; e.g., you would be willing to advance up to $25,000 to $30,000 against the value of a $50,000 property.

It is important to remember two basic facts. First, making a mortgage investment, repayment of which is based solely or mostly on the borrower's credit, is dangerous. There are many things which could happen to discontinue the borrower's good credit, and frequently those things simply may not possibly be foreseen at the time the loan is made. Second, you're examining the value of the property today. As a practical matter, if you have to foreclose on the property, the odds are that after the foreclosure you'll own a property which may require repairs, may have property taxes due, may be uninsured or uninsurable, and in other ways may not be in the same condition as you're viewing it now. The only practical way to protect yourself against these situations is to limit the amount of your financial involvement in this investment.

The higher the loan-to-value ratio, the more likely it is that you'll lose money. And remember that the loan-to-value ratio is affected not only by the value of the property in question, but also by the amount of money you have tied up in the investment. The more you have invested in the mortgage, including accrued interest, advancements made to protect your security position in the property, foreclosure costs, etc., the higher the loan-to-value ratio becomes. It isn't difficult to see that a non-paying mortgage investment can go from satisfactory to very unsatisfactory in a short time as the value of the property drops due to the borrower's neglect and the amount of money the investor has tied up in the investment increases as he goes through the foreclosure process.

As many lenders will tell you, the loan-to-value ratio may be 80% when the loan is made, but, by the time you complete a foreclosure, that ratio may be 100% or more, and that's not good business.

Again, limit the amount of your investment to the amount you know you'll be able to recover if everything goes haywire. The following Mortgage Investment Maximum Funding Determination Worksheet is one tool to help you not invest too much in a given mortgage investment.

Mortgage Investment Maximum Funding Determination Worksheet

Date ____

Borrower ____

Property ____

A. One year's interest at yield $__________

B. One year's insurance premium	$__________
C. Two years' property taxes	$__________
D. Foreclosure cost estimate	$__________
E. Repairs required to sell the property	$__________
F. Real estate sales commission	$__________
G. Closing cost estimate	$__________
H. Other expenses	$__________
Total sales price (in terms of all cash)	$__________
Less total expenses (sum of A through H)	$__________
Net MAXIMUM amount to invest	$__________

Using the Mortgage Investment Maximum Funding Determination Worksheet is fairly straightforward and easy. Since its purpose is to summarize how deeply it is advisable to consider funding a given loan request, it is necessary to approach each of the elements in the form accordingly. Err in the direction of being conservative, not liberal with your money.

Of course, this form is only a tool for looking at a given mortgage investment. Most of the time you'll already feel good or bad about the investment before you ever put your pencil to the paper. What the form does is help you take a better look at what you would have IF the investment doesn't pan out.

And it goes without saying that the form doesn't take every risk into consideration. You need to feel comfortable with this process, so modify it to suit your circumstances as an investor with this particular investment. Here are some ideas for filling in the form:

Under A you should compute the amount of interest that will accrue by using the yield and price at which the mortgage investment is being offered to you. For example, if you're being asked to fund a $10,000.00 loan request and you are being offered a 14% net return, then the number you should enter under A is $1,400.00 ($10,000.00 x .14). This method will tend to give you a number which is high, if anything.

Under B you should enter the actual amount of the insurance premium, if you have it. For a general rule of thumb, single family residential property insurance premiums run in the $150.00 to $300.00 range. If the property offered for security for your investment is unimproved, enter zero in this space. If the property is something other than an average single family home or unimproved land, you should check with a property and casualty insurance agent to get an idea of what number should be entered here.

Under C you should enter a number which is twice the amount of the present year's property taxes. If there's a property tax reserve account, enter one year's property taxes here.

Under D you should enter a best estimate of what it costs to foreclose. In most areas the legal fees run $1,000 and up, depending on the facts of the particular investment. Since probably the first thing the attorney will do after demanding payment is order a title report, you need to include the cost of this title report. For a general rule of thumb and if there aren't any unusual circumstances in evidence, use $2,500.00 as a good estimate of the costs of foreclosing.

Under E you should enter a number which allows you some room to make the property presentable. In some cases this number may be very large, and in other cases it may be negligible. The main things to remember here are that (1) it's unrealistic to expect to receive the property in a condition as good as it's in now; (2) properties in poor condition, particularly on the exterior or the points from which first impressions are made, generally sell more slowly and for less money; and (3) repairs can be far more expensive than you may think. A roof, for example, may cost thousands of dollars to replace. If you have doubts about some particular aspect of the property's condition, it's best to consider addressing those conditions here. If you don't have any particular feelings here, enter $2,000.00 for an average single family home.

Under F you should enter the going real estate commission rate, which you may determine by calling a few real estate offices and asking what commission they'd charge for selling the kind of property in question. One idea here is to increase the amount of commission you'd be willing to pay the real estate broker for selling your property, this in order to stimulate market activity. If given two similar properties to sell, and one has a seven percent commission and the other has a six percent commission, we both know which property the real estate sales agent will tend to show first and with the most passion. Once you have determined the percentage of commission, compute the amount to be entered into F by multiplying that percentage by the value suggested by the person offering you the investment. This method should produce a number which is larger than what is likely to be charged ultimately.

Under G you should enter a good estimate of what it'll cost to sell your property. Usually these costs include title insurance, escrow fees, recording charges, document preparation, and taxes, if any are required in your area. A good estimate of these charges for an average investment runs $500.00 or so. You may check with your local title or escrow company to get a better idea of what to enter here.

Under H you should enter any special costs you anticipate having to pay in conjunction with selling your property.

Where the form asks you to enter the total sales price, enter the ALL CASH value of the property. As discussed earlier, this number may vary considerably from the amount of a sale offering terms typical of the market.

One variation to consider here is to presume that you can sell the property on terms, then compute the net present value of the mortgage investment which results from such a sale.

For example, let's say that you figure you can sell your property for $50,000.00 all cash, or you can sell it for $60,000.00 with $10,000.00 down and the balance of $50,000.00 repayable at $600.00 per month including interest at 12% per annum until paid, some 180.07 months. The net present value of that $50,000.00 mortgage is $45,058.99 at a 14% yield. When added to the $10,000.00 down payment, your investment is worth a total of $55,058.99, and you may consider this approach as acceptable to your investment circumstances. On the other hand, you may have another, better use for your money and choose to accept the $50,000.00 all cash sale. Sometimes the condition or nature of the property may require you to sell on an owner-financed basis, in which case this method is about the only way for you to be repaid. You should keep this factor in mind in determining your suitability to purchase this investment.

When you've entered all of the numbers on the worksheet, it's time to determine the total maximum amount you should consider investing in this particular mortgage, which you accomplish by subtracting the total anticipated expenses from the total cash sales price.

Again, this worksheet is only a tool in helping you assess the extent of your potential exposure to loss in this mortgage investment. Use the tool in accordance with the details of your investment. The major benefit of using this type of tool is to reduce the risk of making investment decisions that are colored by emotional factors, such as your feelings about how nice the borrower or mortgage broker may be or how nice the property pledged as security looks now. It is necessary for you to look at the investment from a realistic, if not pessimistic, posture in order to limit your potential loss.

Chapter Six

BORROWER CREDITWORTHINESS

In mortgage investing, borrower creditworthiness boils down to one question: will the borrower pay this obligation? There are innumerable ways to answer this question, most of which focus on the borrower's history of paying previous debts.

However, before beginning an analysis of the borrower's creditworthiness, remember that the only reason his creditworthiness is at issue is in relation to his likelihood of paying this debt. The best way to ensure that the borrower will pay is for him to have too much at stake NOT to pay.

If you own a $10,000 first mortgage secured by marketable property worth $50,000, the odds are you'll be paid. If you own a $40,000 first mortgage secured by marketable property worth $50,000, the odds that you'll be paid are less attractive. Large equity is usually the best guarantee, and frequently the only guarantee, you might expect to receive in mortgage investing.

Any examination of borrower creditworthiness begins with information found on a loan application form. Although there are numerous forms available, the FNMA loan application shown in Page 82 is most typical. It contains four basic sections.

One section contains recitals relative to this particular loan request and general information about the subject property and the borrower.

The next section details the borrower's income and expenses.

The next section is a financial statement showing the borrower's assets and liabilities.

The last section is a declaration that the information in the application in true and correct, and there's also a formal request for credit. When signed, this document allows a lender the right to obtain certain information related to the borrower's credit.

The credit application is a wonderful tool in evaluating the borrower's creditworthiness. Remember that the less you are certain about with regard to the borrower's creditworthiness, the more certain you'll need to be about the amount of true equity in the property securing your investment.

By studying the application you should be able to answer these questions about the borrower:

Does he earn enough money to live AND also pay this debt?

Does he have a steady job?

Does he have judgments or a bankruptcy in his past?

Does he have assets to sell if he runs into trouble?

Does he have any liquid funds?

Does he have a substantial net worth?

Does his loan application make sense to you?

Most loan applications contain some, shall we say, overstatements as to earnings and assets' values. It's not uncommon for credit lenders to more or less arbitrarily discount asset values by a certain amount to compensate for overestimation of values and liquidation costs.

An image of the borrower should emerge from the completed loan application, and so should questions about him. Any questions should be answered in such a way that you feel comfortable about the borrower. After all, you're considering entering into what could be a long-term relationship with him.

If there is a payment history to the mortgage investment you're considering, examine it closely. Were the payments made promptly and as agreed? It's fair to say that many borrowers pay real estate loans differently from other debts. There may be many reasons for this situation. First, real estate payments are usually a considerable portion of the borrower's income. It's fair to assume that the borrower may have to wait for paydays or receipt of rental income or some other form of income in order to have enough money to make his mortgage payment. Second, many borrowers know that there is a grace period of some sort in most mortgage loans, where they may have no grace period at all on certain other types of financial obligations. If the borrower is experiencing a real cash crunch, it's unrealistic to expect him to make his mortgage payment before he buys groceries. Examining information contained in the loan application can advise you if he's really that close to a break-even cash flow situation.

There are times when the payments have been made late every month, but they have been made consistently on a certain part of the month. Most mortgage investors are more comfortable with this kind of situation than they are with erratic payment histories. Aside from making for a more stable investment with regard to your cash flow, you'll have some method to know the borrower is having difficulties if your payment doesn't arrive according to schedule.

Until now we've discussed using information contained in a typical loan application. However, another very important feature of the loan application is its authorization to a lender to obtain credit information about the borrower. This authorization is significant because it enables the lender to legally order a credit report from a credit reporting agency.

Interpreting credit reports is complicated, and there are numerous forms in which the information is presented. Typically, a credit report will tell you the current payment status of loans held by lenders reporting to the credit reporting agency, and it will contain a summary of past late payments and any notices the credit reporting agency has been given as to judgments, marital litigation or bankruptcy proceedings.

The credit reporting agency will be happy to explain the data contained in the report. The report is not necessarily one hundred percent accurate, as the credit reporting agency doesn't usually verify the data it receives from reporting lenders. When errors are encountered they are corrected, but it usually takes the issuance of an incorrect report for the errors to be discovered.

The credit image of the borrower should be fairly clear by looking at his credit report, payment history and loan application. However, sometimes mortgage investments don't come with credit reports or loan applications. This situation is particularly true in cases where the mortgage was created when a seller carried back some of the purchase price on the sale of real estate.

Seldom do real estate sellers do much in the way of credit examination of the buyers. In cases where you have no loan application or credit report to rely on, the payment history is about the only credit tool available. What you can do in such cases is ask for more information about the borrower. The current mortgage holder can probably tell you something about the borrower, and asking the borrower himself for more financial information is another approach. Although he's not required to give you any information, often he will if asked. Get him to fill out a loan application if possible. If this isn't possible, you should use the form as a guide in selecting the questions to ask him.

Before doing anything in the way of contacting the borrower's creditors, you should check with your attorney, as there are many laws, both state and federal, dictating what you can and cannot ask and how and when you can ask questions related to credit matters. The penalties can be severe and can be totally avoided by checking first.

Chapter Seven

THE VALUE OF ESCROW SERVICES

Most people don't have a good understanding of exactly what escrow services are and how vitally important they are to a mortgage investor.

Escrow can easily make the difference between a successful mortgage investment and a financial disaster.

In any escrow, a disinterested third party acts as escrowee, or escrow agent, to execute instructions given by two parties regarding the disbursement or collection of funds and documents related to real estate. This escrow agent may be an attorney, title company or escrow company. Escrow agents are regulated and licensed by the state in which the escrow services are rendered.

The vast majority of escrows are closed by title companies offering escrow services or by independent escrow companies.

There are two kinds of escrows we'll be discussing: closing escrows and collection escrows. Each type represents an important part of mortgage investing.

Closing Escrows

A closing escrow may be set up when ownership of a property or the right to collect payments secured by property is transferred from one party to another, or when a new mortgage loan is created.

In a typical closing escrow, the buyer and seller give written closing instructions to the escrow agent. In the closing instructions the exact details of the sale are disclosed.

In most real estate sales transactions the process begins by the escrow agent's receiving a written earnest money agreement already executed by both the buyer and seller. The escrow agent then prepares the escrow instructions which provide the agent with the exact specifications needed to perform the terms outlined in the earnest money agreement. When the escrow instructions are signed by the buyer and seller, the escrow agent then has the proper authority to draw the proper documents, collect any money required under the agreement between the buyer and seller, and, ultimately, to close the transaction.

The benefit the buyer and seller are receiving in a closing escrow is the proper fulfilling of their agreement to transfer the property. The seller knows that his property won't be handed over to the buyer until he's been paid as agreed, and the buyer knows that his money won't go to the seller until he's received title to the property he's buying.

The escrow agent will not close the escrow until all the terms of the agreement between the buyer and seller have been fully met or modified by mutual consent of the buyer and seller.

When a mortgage investment is being created initially or transferred from one party to another, a closing escrow is an important part of the process.

In the case of the creation of a new mortgage investment, a closing escrow is important because it allows the investor to know that his funds won't be disbursed until certain conditions relative to this particular investment have been met; i.e., that any liens needing to be paid off are, in fact, paid off, or that the vesting of title to the property is as the investor understands it to be.

The investor executes written escrow instructions, something like the following, to the escrow agent. Notice the kinds of details the investor has addressed in the instructions:

> *Enclosed is my check made payable to you in the amount of $50,000.00, a promissory note from Borrower to Investor, a disclosure form from Borrower to Investor, and a trust deed from Borrower to Investor. I make reference to Brand X Title Company's preliminary title report No. 12345, dated June 18, 1988.*
>
> *You are authorized and instructed to have the enclosed trust deed, disclosure form and note properly executed and to record the trust deed at such time as you are able to provide me with a standard mortgagee's title insurance policy in the amount of $50,000.00, showing vesting in Borrower and subject only to exceptions No. 1 (a beneficial utility easement) and 2 (protective covenants for that subdivision) disclosed in the above title report, at which time you may disburse the enclosed funds to Borrower.*
>
> *You are to pay all taxes and liens, and you are also to have in your possession prior to closing a receipt for the payment of one year's premium for fire insurance in at least the amount of $50,000.00 covering the subject property and containing Paragraph 438 BFU provisions and naming me as first party payable in the event of loss.*
>
> *Borrower is to pay all closing costs associated with this transaction.*
>
> *Please forward the trust deed, insurance receipt, title insurance policy and trust deed to the above address and immediately send the executed promissory note.*

The above example is not intended to address every possible mortgage investment's situation, but you may see that the closing escrow instructions describe what the investor has required in this case. He has told the escrow agent what he's given, e.g., documents and money, and what he needs in order to allow what he's given to be used by the escrow agent.

Escrow instructions need to be utterly clear and unambiguous.

The reasons that closing escrow instructions are important to a mortgage investor are that (1) without them, it's uncertain just what, if anything, it is the investor may receive for his money and (2) if there is a problem in performance of the terms of the closing escrow instructions, the escrow agent is responsible and liable for damages created by his mistake.

Escrow fees amount to a few hundred dollars on a typical mortgage investment, and it's not at all uncommon for the mortgage investor to negotiate with the borrower or mortgage broker for the closing escrow fee to be paid by someone other than the investor. In any event, the risk of closing without a closing escrow outweighs the costs of using a closing escrow.

Not all escrow agents carry adequate errors and omissions insurance, and the bond required of escrow agents by most states is not necessarily enough to cover the amount of your investment. It is for these reasons that it is generally recommended that you use large, financially sound escrow or title companies to close mortgage investment transactions.

Another good reason to use a closing escrow in a mortgage investment transaction is that you'll receive a closing statement for your records. Having a complete and well documented file for each mortgage investment you make is important for many reasons, not the least of which is that you may need to review the mechanics of a given mortgage investment years from now, and it's unlikely that you'll recall the exact specifics of this particular investment.

Collection Escrows

Collection escrows differ from closing escrows only in that they deal with the on-going collection of money and delivery of documents provided in most mortgage investments. Where a closing escrow is finished when the documents have been properly executed and the funds have changed hands, a collection escrow continues until the final payment under a mortgage has been made.

In a collection escrow the borrower and investor execute written collection escrow instructions to a collection escrow agent, who may be an attorney, title company, escrow company or bank. Typical collection escrow instructions provide that the agent collect the payments stipulated in the promissory note and mortgage and that he deliver an already-executed satisfaction of mortgage document to the borrower when the last payment has been made.

The collection escrow agent receives payments from the borrower, maintaining a proper accounting for each payment. The agent first pays his collection fee, which is usually a few dollars for each payment received, and then remits the balance of the payment as he's been instructed. Usually the balance of the borrower's payment is sent to the investor or the investor's account at a bank.

At the end of the year the escrow agent will provide both the borrower and the investor with accounting information suitable for Internal Revenue Service purposes.

The collection escrow agent holds satisfaction documents until the last payment has been made, then typically delivers them to the borrower. When the last payment has been made and the satisfaction documents have been delivered, the collection escrow is terminated, as its purpose has been fulfilled.

Collection escrows are important to the investor because they provide a means for handling proper accounting of funds received and IRS reporting. There have been cases of mortgage investors who have incorrectly computed interest payments over a period of years, and who then have been sued by their borrowers. Even if the calculation error is small, it can amount to a huge sum when compounded over the life of a long-term loan.

Aside from the monthly fees, there is a set-up fee that can run up to a few hundred dollars. Many mortgage investors will negotiate the costs of a collection escrow with the borrower, and for good reason.

The borrower gains much by having a collection escrow. First, he knows that when he makes his final payment, satisfaction documents are waiting for him with the collection escrow agent.

Second, he knows that his payment will be properly computed. And, third, he knows that he will receive timely and accurate accounting information each year for IRS purposes.

Although the scope of this publication is not directed at making mortgage investments other than in first position, you should be aware collection escrows are absolutely vital in keeping secondary mortgage investments from getting out of control.

Here's an example of how a second position mortgage investment went out of control:

> *You made a $5,000 loan to a borrower who had a $50,000 property which already had a $20,000 first position loan to Brand X Bank. The borrower made all his payments as agreed with you, and you thought everything was fine until the county sheriff knocked at your door and gave you notice that you and the borrower were being foreclosed upon by Brand X Bank for non-payment of its $20,000 first position loan.*
>
> *Brand X Bank accelerated the entire balance and was foreclosing judicially, so now the entire balance of their $20,000 loan, plus accrued interest, penalties and foreclosure costs had to be paid in full.*
>
> *You are now forced to either pay off the Brand X Bank loan in full to protect your investment and then foreclose the borrower's interest, or walk away from the property.*

Of course, there may be ways you could recover your investment in this case, such as going after the borrower individually or hoping that at Brand X Bank's sheriff's sale the property sells for more than what's owed to Brand X Bank.

But collection escrow services make this kind of situation unnecessary.

Had the above investor set up a collection escrow which provided that the borrower make his entire payment, e.g., the payment on the Brand X Bank's $20,000 loan and the investor's $5,000 loan, into the collection escrow, then each time the investor received his payment he would have known that Brand X Bank had been paid. In such escrows the agent is instructed to first pay the escrow agent's fee, then pay Brand X Bank, and remit the balance to the investor. If the investor didn't receive his payment, he'd know that he'd better follow up with the borrower.

Chapter Eight

MORTGAGE BROKERS

Collection escrows are underused in most areas, yet they provide a measure of protection that is indispensable in mortgage investing.

Mortgage brokers operate in most areas and can be a good resource for mortgage investors. Frequently, they facilitate prudent mortgage investing, and their experience can assist you in assembling all of the information you need to make good mortgage investment decisions.

A mortgage broker typically finds a prospective borrower who is requesting a loan which the mortgage broker is fairly confident he can convince a private mortgage investor to purchase. Mortgage brokers also buy, and then resell at a profit, real estate secured notes and contracts.

Some mortgage brokers work strictly as brokers, i.e., they obtain an option from the borrower to fund the borrower's loan request. In this mode of operation, the mortgage broker packages the borrower's loan request into a form which he then presents to private mortgage investors. If he is successful in finding a mortgage investor willing to fund the requested loan, the mortgage broker is paid a fee, usually by the borrower.

Some mortgage brokers have money of their own to invest, and they use this money to immediately fund approved loans. They then hold the funded loans until they can find private mortgage investors willing to purchase the funded loans. When the funded loans are sold to the private mortgage investors, the mortgage brokers' funds are again available for making new loans.

Some mortgage brokers specialize in the purchase and resale of existing real estate-secured paper. One of the primary benefits of purchasing existing mortgage investments is the seasoning, or establishment of a payment history, upon which you may make a determination as to the payor's likelihood of making payments into the future. As a general rule, when the payor has been making timely payments for several years, he is likely to perform as agreed. The fact that a given mortgage investment has been satisfactorily paid, or seasoned, for a long period of time is a good sign.

Most mortgage brokers make their money by charging loan fees to the borrower when requested loans are funded, but some mortgage brokers earn additional fees, usually paid by the mortgage investor, for on-going servicing of the loan. Servicing usually includes monitoring or processing the payments, making sure fire insurance remains in effect on the subject property, and getting in touch with the borrower in the event of a default.

Most states regulate mortgage broker activities and require that each broker be licensed. Check with your state government's commerce division, usually in the department which regulates professional real estate activities and securities, to determine what the state requires of mortgage brokers. Ask for specific information about the status of the mortgage broker you may be using, including any complaints which have been lodged against him with the state.

In many states there are several categories of licenses under which the mortgage broker may operate. Details concerning the limitations under which your particular mortgage broker may have to work may be determined by speaking with the state. Make sure that the mortgage broker you're working with is properly licensed to deal in this type of investment, and make sure that he is in good standing with the state.

Mortgage brokers are required to perform the act of mortgage brokerage with due diligence. Due diligence means that he must act in good faith in disclosing to you all material facts, good and bad, about a given transaction, and that he must determine that you, as an investor, are suited to this particular investment. Mortgage brokers can't recommend that you purchase a given mortgage investment.

As one quickly comes to know in any type of real estate investing, a prospective transaction may look wonderful on paper but, in fact, be fatally flawed in many respects when scrutinized in the proper ways. A mortgage broker who has complied with his duty of due diligence helps determine the true facts relevant to a given mortgage investment. This process is of great value to a mortgage investor.

Finding a competent mortgage broker is an excellent way to get off to a good start in mortgage investing. It is only prudent for you to understand, however, that there are times in most mortgage investment transactions when your interests and his interests will not be the same. For this reason it is important for you to know how and where his compensation comes from on each transaction in which you're involved. Then make sure that you have verified the information he has supplied you which induced you to invest your money.

If you receive any kind of guarantee from a mortgage broker, don't count on it. First, although some may be legally licensed to make guarantees, most mortgage brokers are restricted by law from making any out-and-out guarantees in the sale or brokerage of mortgages. Second, a mortgage broker would have to be almost limitlessly wealthy to make good on guarantees made over a long period of time. Even small mortgage brokerages handle hundreds of thousands or millions of dollars in mortgage transactions each year. Just how good your transaction's guarantee would be if called upon in the future is quite uncertain. And, third, remember that the only real guarantee you may expect to receive in mortgage investing is the value in the property being pledged to secure repayment of the money you've invested.

Always ask for copies of any documents or information disclosed to you by the mortgage broker, then read them closely when you have enough time to really concentrate. When you are looking at a favorable mortgage investment, the closer you look at the details the better you'll feel about the transaction. And if you do find troubling details overlooked by the mortgage broker, you're both better off finding out now.

The best defenses against making a poor mortgage investment are doing your homework, doing your homework well, and doing your homework BEFORE you invest your money.

If you do use the services of a mortgage broker, be sure to use them in conjunction with, and not in place of, the services of your attorney, a title company and a closing escrow agent.

Included as an exhibit in this book is a copy of the basic regulations the State of Oregon has applied to mortgage brokers. You should review these regulations if you use the services of an Oregon mortgage broker.

It should be noted at this point that guarantees aren't necessarily a bad thing. Guarantees made legally and under certain circumstances may add a good measure of confidence in a given mortgage investment. The idea is to make certain that you understand exactly what it is you're to receive in your mortgage investment; if the guarantee is what makes the investment attractive, make sure that you understand the nature of the guarantee and the potential limitations of the party making the guarantee.

Chapter Nine

COLLECTIONS AND FORECLOSURE

The most obvious fear mortgage investors have is that their investment will not pan out. Even if you fully expect your investment to perform, what's true is that many mortgage investments have taken unprepared investors through the potentially negative process of collection and foreclosure, then ownership and sale of the property. Knowing what this process is about is a very important part of doing your homework.

Every financial obligation, e.g., promissory note or contract, has some sort of due date for one or more payment. This chapter deals with only truly delinquent investments, and we'll define truly delinquent as being over 30 days past due.

Certain promissory notes and contracts contain late charge provisions which may take effect prior to the loan becoming 30 days past due, and there's generally nothing which prohibits you from sending late payment notices and making demands for payment prior to the loan becoming 30 days past due.

However, even if your attorney verifies the legality of your position in making demand prior to the payment being 30 days past due, as a practical matter, pressing for payment of a loan less than 30 days late may create more problems with the borrower than it will solve.

At this point it is a good idea to discuss what your style of debt collection might be. There are benefits to being assertive in collecting unpaid debts. There are also benefits to not being overly aggressive in debt collection. The extremes are hammering the borrower each month for being a few days late and not doing anything about a late account for months on end. Most successful debt collectors deal between these two extremes, being firm but fair in their dealing with delinquent accounts and being prompt in addressing all delinquencies.

Never let a delinquent investment remain delinquent for long. Define the payment problem and then resolve it as quickly as possible. See the section later in this book about waiver, as letting late payments go without acting to collect them may set up a defense for the borrower in not making future payments on time or in failing to observe any balloon payment due dates.

Sometimes it is simply impossible to resolve the problems behind a delinquent investment. But other times your flexibility and willingness to communicate with the borrower make it possible for you to avoid a more costly resolution via foreclosure, then ownership and sale of the property.

And, of course, if you should try to communicate with the borrower and be flexible in your approach to resolving the delinquent investment, and the borrower is uncooperative or abusive, you may well find that it is easier to go through the foreclosure process more aggressively.

As you examine the time, money and effort required of you during the foreclosure process, you may determine that initial flexibility in your position is the best option for you.

The differences between the various types of investment documents, e.g., mortgages, trust deed and contracts, were mentioned in some detail in Chapter Three.

Essentially there are two types of foreclosures: judicial and non-judicial. Each takes a different approach to seizing the pledged property to help satisfy the borrower's debt.

Before foreclosure commences, however, you must provide the borrower with proper notice that his payment is late.

A good system to follow is the so-called 10-20-30 program, which provides for late notices to be sent 10, 20 and 30 days, respectively, after the date the payment was due. The demands for payment are stated in increasingly aggressive language as the delinquency matures.

If payment has not been received within 30 days, it is time to contact the borrower. Letting delinquencies continue beyond 30 days without contacting the borrower is rarely advisable, if for no other reason than it sets a precedent that you've accepted late payments.

Find out what the borrower's situation is and make a determination as to his intention to pay what's owed. If you aren't satisfied with the course of your conversation with the borrower, you should immediately send a demand letter which states the exact delinquency and makes formal demand that the borrower pay within a short time, usually 10 to 15 days.

If the borrower doesn't perform within the grace period defined in your demand letter, you should contact your attorney and ask him to send a demand letter. Even though his letter won't say much that's different from your earlier letter, sometimes just the fact that the letter comes from an attorney will get the borrower's attention.

Collections not successfully concluded within 60 days of the date the initial payment was due usually signal a situation requiring a foreclosure action. Although there certainly are exceptions, you should concentrate your efforts on getting delinquencies addressed immediately. Delinquencies don't generally improve with age.

Foreclosure is not the only way to recover property tied up in a past due account. You may accept a deed in lieu of foreclosure under certain circumstances. Typically this situation requires several conditions to be in place. First, you must have the co-operation of the borrower in deeding the property to you. Second, you need to have done title work to determine that there aren't other liens which, when you accept the deed in lieu of foreclosure, attach to and unacceptably encumber the property you're about the receive. And, third, you'll need to consult your attorney to draw a proper document, as there are technical reasons you'll want to include what's referred to as non-merger language, and accomplishing this is best left to your attorney. There may be additional considerations as well, such as complications of bankruptcy, making it prudent to consult your attorney.

One last point is to make sure you understand the rules you'll need to follow in collecting any debt. Most states have very specific regulations about when, how and how often you may ask for your money. The regulations are specific to the point of requiring you to identify yourself and the nature of your call within the first few seconds of making contact with the borrower, for example. Be sure to have your attorney provide you with all of the regulations BEFORE you make a call.

One example of this point is that in many states it is required that you remind the borrower each month in writing that there'll be a late charge if he doesn't pay within a specified period. Without this warning, in many areas you would have difficulty in collecting any late charges. It's not a problem to provide the proper notice, but you'll need to know just what it is that you have to do.

Chapter Ten

PROPERTY AND CASUALTY INSURANCE

One area often overlooked by mortgage investors is insurance. There are many types of insurance which provide mortgage investors with an added measure of protection against unforeseen losses, and you should be familiar with the most important ones.

In addition to title insurance, which we've discussed in some detail earlier, the areas of basic concern to a mortgage investor are insuring the borrower, insuring the property pledged as security for the loan, and insuring the mortgage itself.

Insuring the Borrower

Insuring the borrower is an excellent idea. Many times the success or failure of the plan to repay you will depend to a large degree on the borrower being around and able to implement his plan to repay you.

The borrower may usually buy life insurance in the amount of your investment. The policy would name you as the beneficiary and would cancel the debt should he die before the loan is paid off.

Sometimes this type of insurance is called credit life insurance and is offered by companies who specialize in such underwriting. Usually there will be few, if any, medical questions or examinations required to obtain coverage.

Of course, the borrower could always simply go and buy a standard life insurance policy, probably a term life policy, at a minimal cost.

From your perspective the key here is only to be aware that it is an excellent practice to ask for some sort of life insurance coverage on the borrower. Making the borrower provide you with such coverage may make a difference between feeling good or bad about a given investment.

Disability insurance is also a possibility. Rates and terms for disability insurance vary considerably, but knowing that the borrower will continue to have an income even if injured or otherwise incapacitated is comforting to most investors.

You should call your personal insurance agent and ask him how much he would charge to provide a given borrower such coverage. With these numbers in mind you can assess the impact your demand that the borrower provide the coverage may have.

As is the case with any kind of insurance coverage, don't presume that you'll be notified in the event that coverage lapses. Sometimes this presumption is valid, sometimes it isn't. Prepare a tickler file which tells you in advance of the lapse date and reminds you to verify coverage with the insurance underwriter or agent.

One word of warning: insurance agents are not infallible and may make an error which costs you money. ALWAYS get written proof of coverage, and ALWAYS read what you receive.

Another warning: know that there is a difference between an insurance binder and an insurance policy. A binder is just an interim commitment from the agent to provide coverage, and this commitment is usually only valid for thirty days. A policy has a definite and stated expiration date and is typically thick with more or less inscrutable limitations as to the underwriter's liability.

These warnings apply to most types of insurance, including real property insurance.

Insuring the Property

The thinking behind having the pledged property insured is simple enough: if the building burns, you'll be paid off. The details behind the insurance are a bit more complicated, however.

One of the first considerations is the basic insurability of the property. Many types of property are difficult to insure.

Properties which are vacant, extremely rural, structurally questionable, in hazardous areas (such as flood zones, slide areas, etc.), mixed use properties (such as one building which houses a tavern, residential rental units and a store), industrial properties, or properties under construction are typically difficult to insure.

Don't disburse your funds until you're certain that the property can be insured.

The amount of coverage needs to match or exceed the amount of your investment. Exceptions to this rule usually are cases in which the value of just the land, exclusive of any improvements, comprises a significant portion of your investment.

One point to remember is that if fire should destroy the improvements on your property, and if for some reason you ended up owning the property, you'd be left with a considerable and probably expensive job of cleaning up the site. This type of work can cost up to thousands of dollars and sometimes isn't taken into consideration in the insurance coverage you may be provided.

Arson is not a covered loss in all cases. Make sure that you are provided with coverage for loss by means of arson. From your perspective, if the property is destroyed by fire, how the fire started is of far less concern to you than getting paid for the loss. Typically this coverage is in place if you have what's referred to as “Paragraph 438 BFU” in your policy. In any event, ask for proof that you're covered if the property is destroyed by anyone's arson.

Another possibility in the case of covered damage to the property is the borrower rebuilding or repairing the property. He certainly has the right to restore the value of the property securing your investment. This is, of course, in your best interests, too. The point is that with proper insurance in place you may expect to receive money or the property restored to the extent of coverage under the policy. Theoretically, either option should provide you with a good measure of protection.

Chapter Eleven

FINANCIAL MATHEMATICS

Did you know that there's a difference between interest and yield? Many investors do not know that there is a difference, what causes the difference, or how to calculate it.

Interest is typically expressed in annual terms: e.g., 12% interest is more correctly referred to as 12% interest per annum, or over the period of one year, interest will accrue in an amount which equals 12% of the balance owed.

Interest may be paid in any agreed schedule, including monthly, quarterly, semi-annually or annually. The total amount of interest earned, in terms of dollars and divided by the principal balance, in one year equals the interest rate. For example, a $10,000 investment bearing interest at 15% per annum produces $1,500 per year, and may be repaid at $125 per month, $375 per quarter, $750 every six months, or $1,500 in one lump sum payment.

However, you can boost your yield by re-investing the interest payments you receive along the way. Total return received in one year is more properly expressed as yield, and it takes into consideration factors additional to simple interest earned.

If, for example, you had your $10,000 investment set up to pay interest monthly and you were to re-invest your monthly interest payments at five percent, your total return would work out to be as shown in Figure 2.

REINVESTMENT OF INTEREST

Month	Payment	Interest on Payment	Total Earned
	$125.00	$0.00	$125.00
2	125.00	.52	125.52
3	125.00	1.04	126.04
4	125.00	1.57	126.57

5	125.00	2.10	127.10
6	125.00	2.63	127.63
7	125.00	3.16	128.16
8	125.00	3.69	128.69
9	125.00	4.23	129.23
10	125.00	4.77	129.77
11	125.00	5.31	130.31
12	125.00	5.85	130.85
Total	$1,500.00	$34.87	$1,534.87

Figure 2

As you can see in Figure 2, if you had deposited your monthly interest payment into an account bearing only five percent interest, and you had the discipline not to touch the account during the course of a year, you'd find that instead of having just the $1,500 in actual interest your $10,000 had produced, you'd have accrued an additional $34.87. Although the investment was bearing only 15% interest annual interest, you would have received an overall annual return, or yield, of 15.3487%.

Mortgage investments, as a rule, are simple interest investments. That is, interest is generally not charged on accrued interest. Although the compounding effect of charging interest on interest is significant, in most states there are prohibitions against this practice.

Let's say that you have a $10,000.00 investment which was originally set up to be repaid to you at $100.00 per month and was to bear 10% interest until paid. We'll call this Investment “A.” If all payments were made exactly on the dates corresponding to increments of one-twelfth of a year and were exactly $100.00, then this investment should take 215.91 months to amortize fully; e.g., you'd receive 215 payments of $100.00 each and a final payment of $89.86 on the 216th month. The total amount of dollars you would receive, then, is $21,589.86 for your $10,000.00 investment, and you'd have all of your investment capital back 216 months from the time you first invested it. Now let's examine some other ways this same investment could work out and what your overall yield would then be.

Let's say that the borrower were to pay you $150.00 per month instead of the scheduled $100.00 per month. Let's call this Investment “B.” The investment would be fully amortized in 97.72 months; e.g., you would receive 97 payments of $150.00 each and a final payment of $106.72 on the 98th month. The total amount of dollars you would receive, then, is $14,656.72 for your $10,000.00 investment, and you'd have all of your investment capital back 98 months from the time you first invested it.

Let's say that the borrower makes his $100.00 per month payment, but he doesn't make the first payment for 60 days; thereafter, he makes a $100.00 payment each month until the investment is paid in full. Let's also assume that your promissory note does not provide for any late charges and that your promissory note provides that accrued interest be paid first, before principal is reduced. Let's call this Investment “C.” By the time he makes his first payment in 60 days, the balance would have grown to $10,166.67. He will have to make 226.39 payments of $100.00 each to pay off this investment. That means that you would have received nothing the first month, then $100.00 for the next 226 months, and one final payment of $38.86 on the 228th month. The total amount of dollars you would receive, then, is $22,638.86 for your $10,000.00 investment, and you'd have all of your investment capital back 228 months from the time you first invested it.

In order to analyze what is happening here, let's make one more assumption. Let's assume that you didn't receive any interest on the principal you received with each monthly payment made along the way, but let's assume that when the entire investment was paid in full you were able to reinvest the $10,000.00 initial investment capital and receive a five percent return until the 228th month.

These variations of a standard 10% face interest rate investment's payback are compared with one another in Figure 3.

MORTGAGE INVESTMENT PAYBACK ANALYSIS

Investment	A	B	C
Invested	$10,000.00	$10,000.00	$10,000.00
Monthly payment	$100.00	$100.00	$100.00
Total # payments	215.91	97.72	226.39
Final payment	$89.86	$106.72	$38.86
Total interest earned	$11,589.86	$4,656.72	$12,738.86
Months to get $10,000	216	98	228
Months $10,000 earns 5%	12	130	0
Total 5% earnings	$500.00	$5,416.67	0.00
Tot interest earned	$12,089.86	$10,073.39	$12,738.86

Figure 3

In the above example, Investment “C” produced the greatest return, mainly because Investments “A” and “B” paid off earlier and we assumed that reinvested capital would only bear interest at 5%. Investment “C” was bearing interest at 10% for the extent of its 228 month term.

One difficulty in analyses of this sort is trying to determine the investment climate at the time the investment pays off. If we had a way to accurately predict the interest rates we might expect in the future, making investment decisions would be greatly simplified.

One point the above example serves to demonstrate is that the method of repayment and the calculations of accrued interest and principal reductions all greatly affect the terms of the investment.

For example, Investment “A” would take 215.91 months to pay off, where Investment “C” would take 227.39 months to pay off. The difference (almost one year of payments) is caused by just one $100.00 payment not being made on time. It isn't hard to imagine that many, small delays in receiving payments on time can dramatically lengthen the time it takes to pay off a given mortgage investment. Conversely, payments made early and/or for amounts greater than scheduled can dramatically shorten the time it takes to pay off a given mortgage investment.

Because of this situation, it is again appropriate to mention the importance and benefit of collection escrows. When a mortgage investment is properly established in a collection escrow, you will know that calculations are made correctly. You'll also have some assurance that if a mistake in calculation is encountered, someone else is responsible for the mistake.

Another point the above example illustrates is that the rate at which repaid principal is re-invested is a critical factor in optimizing your overall yield.

Let's say that you have a $10,000.00 mortgage bearing interest at 12% per annum, and on this month you receive $10.04 in principal. Since calculators typically assume that any principal you receive will be re-invested at the same interest rate the calculator has in memory, the calculator would presume that you could and would re-invest that $10.04 and receive the same interest on the re-invested sum that is in the calculator's memory, or 12% in this case. While reinvesting at high interest rates these small amounts of principal received may be possible, it certainly isn't likely to be possible for each and every bit of principal received during the life of the mortgage to be reinvested at or above the yield at which you purchased this investment. You should keep this point in mind, particularly when you consider long-term, amortizing mortgage investments.

While properly calculating interest is an important issue with any mortgage investor, the concept of the present value of money is also fundamental.

Net Present Value

If someone you know pretty well and think is responsible wants to borrow $10.00 from you and promises to pay you back later today, the odds are you'd lend the money and not think too much more of it.

But what would you do if that same person wants to borrow $10.00 from you and promises to pay you back in twenty years? Would you be as willing to lend your money? If you did lend the money, would it seem that somehow you should be compensated for your extension of credit?

This general concept is known as the present value of money. Very sophisticated calculations translate the borrower's promise to give you money in the future into net present value in terms of today's money.

If, for example, a given mortgage investment is set up to bear interest at 8% per annum, and the current mortgage investment market yields 12% per annum to willing mortgage investors, then the net present value of the mortgage investment is going to be less than the face amount owed on the mortgage.

When a given mortgage investment's net present value is less than the amount owed on the mortgage itself, the difference between these two numbers is described as the discount. Discount may be expressed in terms of dollars or as a percentage of the mortgage's present balance owing.

All discount really means is the amount necessary to compensate an investor for purchasing an investment which, by its strict terms, does not produce a return as high as the investor might receive on other, similar mortgage investments.

What happens if the current mortgage investment market yields 12% per annum, and the mortgage investment in question yields 15%? Should you pay a premium for receiving the higher yield?

The only reason to pay a premium for a mortgage investment is under the condition that the investment can't be paid off early, or that you'll collect all the interest to have been earned over the life of the mortgage upon an early payoff.

Let's look at the example of a $10,000.00 mortgage bearing interest at 15% per annum, repayable at $150.00 per month until paid, some 144.23 months. To produce a 12% yield, a mortgage investor should, theoretically, be willing to pay $11,428.93 for this mortgage. But think how foolish you'd feel if you had paid over $11,000 for this mortgage, only to have the borrower pay off the $10,000.00 balance owing in full the next day. This wouldn't be a very good mortgage investment!

There are many ways to calculate interest and net present value, and you need to know just how the investment is to be calculated.

Many promissory notes state the manner in which interest is to be calculated; however, the majority simply state the interest rate.

For most mortgage investments, calculating accrued interest is done by counting the number of days between the date of the last payment and the date of this payment. The outstanding principal balance is then multiplied by the annual interest rate, and divided by the number of days in a year. When the number of days since the last payment is multiplied by the amount of interest accruing each day, the result is the amount of interest accruing since the last payment date. Here's an example:

Let's say that the balance owing on your mortgage investment was $12,758.85 after the last payment was made on May 21, 1988. Today is June 18, 1988, and you've received another monthly payment of $150.00. Your investment bears interest at 9% per annum.

First, you determine that there are 28 days between May 21, 1988, and June 18, 1988. This can be done by using a calendar or by using a calculator with a calendar function. Next you determine that 9% interest on the balance of $12,758.85 ($12,758.85 x .09) equals $1,148.30, which is $3.15 when divided by 365 days. When you multiply $3.15 (which is the amount of interest accruing each day on the balance owed) by 28 (the number of days since the last payment was received), the result is $88.20 in accrued interest since May 21, 1988.

Next, you need to subtract the accrued interest from the $150.00 payment you've just received, and that should leave you $61.80, which is the amount of principal the borrower has reduced with this payment.

All that's left to do now is to properly post the results. Most ledger cards provide spaces for the date of the payment, the amount of the payment, the amount of interest paid, the amount of principal paid, and the resultant principal balance owing after this payment has been posted. The person calculating the payment usually initials the ledger card, too.

One mistake many mortgage investors make is to rely upon a pre-printed mortgage amortization table to track the borrower's progress on making his payments. The problem with this method is that the odds are very limited that the borrower will make each and every payment exactly on the date specified on the pre-printed table. And as we've seen in the examples above, variations in the dates upon which the borrower makes his payments can dramatically affect the resulting balance due.

As in other cases, the best idea here is to avoid problems where at all possible. Don't rely on a pre-printed amortization table to tell you what's owed on your mortgage investment. If you're wrong one way, you'll lose money owed to you. If you're wrong the other way, you may have the borrower present a demand to you someday in the future for improperly computed/collected interest. It's best just to do it right from the start.

Net present value calculations are much more complicated. The most common method of calculating net present value starts by defining the cash flow the mortgage investment is scheduled to produce, then performing an internal rate-of-return mathematical analysis on that cash flow. This internal rate-of-return analysis will determine the amount an investor should pay for a given cash flow based on a given yield the investor requires.

For example, an investor who requires a yield of 14% can afford to pay a maximum of $8,473.43 for a $10,000.00 mortgage repayable at $150.00 per month, including interest at ten per annum until paid, some 92.77 months. $8,473.43 is a calculator number which resulted from entering information about this mortgage's anticipated cash flow and bouncing that cash flow off the investor's 14% yield requirement. One very basic point worth mentioning is that you should always define what you're expecting to receive in terms of cash flow; e.g., $150.00 per month for 85 months, then $35.88 on the 86th month. If you want to invest in a calculator, there are several calculators and computers on the market and most are fine for mortgage investment calculation purposes. Most of these calculators are $100.00 or less. Make sure that you understand what you're to receive in this mortgage investment. Consult a competent mortgage broker to see what he'd recommend. The investor should be able to obtain satisfactory answers to these questions.

When/if you buy your calculator, take plenty of time to read the literature coming with it. It might be a good idea to enlist the assistance of the person giving you a recommendation as to a particular calculator. Unless you're superhuman, the odds are that you'll need some help.

Another approach is not to bother with a calculator at all. You can always hire or otherwise obtain the services of a mortgage broker to help you with calculation problems. And since the result of advanced financial calculations, such as net present value and internal rate of return, are very important factors in your decision to make a given mortgage investment, there's much to be said for getting professional assistance in this area.

What we've discussed here is fairly basic and generic to most mortgage investment scenarios. However, there are numerous wrinkles in calculating and other financial mathematics problems. You'll have to rely on common sense to get the answers you'll need. Between your attorney, your mortgage broker and a competent collection escrowee you should be able to make your mortgage investments successful.

Chapter Twelve

SPECIFIC PITFALLS TO AVOID

Many items of potential concern to mortgage investors don't really fall into any of the categories we've discussed, although each pitfall is worth mentioning.

Usury

Usury is a term which describes a rate of return that is excessively high under certain circumstances. The legal definition of usury is different in most states.

Be sure to check with your attorney about usury. In most states making non-usurious, yet high-yielding mortgage investments is no problem, but you need to know the rules.

Penalties for making or collecting usurious sums run from forfeiture of interest to even more severe penalties. Be sure to verify your position with regard to usury before you make a mortgage investment.

Bankruptcy

Bankruptcy laws have been passed by the United States Congress and may affect every mortgage investor. A borrower may declare bankruptcy under any one of several bankruptcy law chapters. Each chapter provides for repayment, forgiveness or restructuring of debts, but in different ways. The borrower's assets may be sold or merely re-organized under a plan approved by the Bankruptcy Court.

When a borrower declares bankruptcy, the law gives him certain rights automatically, such as a prohibition for any creditor to collect his debt until the Bankruptcy Court has either discharged the borrower's case or the borrower voluntarily reaffirms the debt.

Generally, the mortgage investor's first move is to ask, through his attorney, that he be granted relief from the automatic stay. That is, the mortgage investor asks that he have the right to continue to do what he has to in order to collect the debt the borrower owes him. Getting relief from the automatic stay is sometimes easy and sometimes difficult, depending on the circumstances of the case.

Until this investment has been released from the automatic stay it is difficult for the investor to do anything but wait for the Bankruptcy Court to discharge the borrower's case.

Although all of the foregoing has been negative, there are some positive points here which need to be emphasized.

First, if you only invest in properties in which the borrower has a substantial equity, the odds are that the borrower will sell the property securing your investment before he would declare bankruptcy.

The reason for this situation is that, theoretically, in bankruptcy the borrower hands all of his property to the Bankruptcy Court, which then appoints a Trustee to handle the borrower's property, pending disposition of the borrower's bankruptcy case. The Bankruptcy Court gives notice to all of the borrower's creditors, secured and unsecured, that the borrower is going bankrupt. Whatever proceeds result from disposition of the borrower's property go to pay all the borrower's creditors, secured first and unsecured second.

If a borrower has a true equity in the property he has pledged as security for your investment, it is far more likely that he'd just sell it and pocket the proceeds, rather than, in essence, give the property to all of his unsecured creditors, such as merchants, credit card companies, etc.

Offsetting this positive point is the possibility that the borrower may have borrowed money from another source after your loan. In this case, the borrower would have less equity, or perhaps no equity, to be interested in preserving or trying to realize through selling the property. It is generally advisable that the security document you use contain a provision that borrowing against or selling this property is prohibited. Although this prohibition is not a 100% guarantee that the borrower won't do something with his equity, it is an easy thing for you to do and may complicate any effort on the part of the borrower to make accepting a deed in lieu of foreclosure less possible or desirable for you.

Second, in mortgage investing, you are a secured creditor. Your interest, therefore, will always come before the interests of other, unsecured creditors. Although there will be an interruption in income for you during the period of bankruptcy, you will most likely recover your investment. This is not so for unsecured creditors.

It is impossible to make any type of loan without running into the risk of having your borrower declare bankruptcy. Using a large margin of equity and having a competent and diligent attorney are your best defenses in these cases.

Truth-In-Lending Requirements

Because of abuses by many lenders over a period of years, the federal government required lenders to provide borrowers with certain information about the loans being offered and the right to rescind a loan under certain circumstances. These laws are commonly known as “Regulation Z” or “Truth-In-Lending” laws.

Disclosure is the central theme of these regulations. In order for the borrower to know what the overall cost of his loan is, the lender is to provide him with a number of details, including Annual Percentage Rate (APR) computation. What the government is requiring here is that the borrower have the benefit of disclosure of the true and actual costs of borrowing money. If he pays five percent interest but has loan origination and other fees, the total interest rate he's paying is going to be higher than the five percent face interest rate on the loan. Disclosure of these kinds of details is not only the law, it's simply a fair way to do business.

When the borrower pledges his own personal residence as security for the loan, he has additional rights. He must be granted a three-day period in which to rescind the loan. Only conditions of extreme, documented hardship on the borrower if the loan is not closed before this period expires release the lender from this requirement.

There are certain conditions under which Truth-In-Lending requirements may not exist, but you are well advised to consult your attorney about your particular mortgage investment. Penalties are severe and totally avoidable by doing your homework first.

One point to consider is that even if the law doesn't specifically require you to provide full disclosure of the effective cost of the loan you're extending to the borrower, common sense says that you should. You would expect the same from someone extending credit to you.

Land Use Restrictions

There was a time when a property owner could do whatever he wanted to with his property, but that time has long since passed. Because of a number of factors, including environmental concern and community desires for orderly growth, land use planning has been done in most areas. Land use planning is perfected by means of laws and regulations which allow and disallow certain uses of land in a given area.

Although this point may not affect the mortgage investor who has a single family home in a fully-developed subdivision as security for his investment, it is likely that you will at some point come into contact with a potential land use planning issue. Unimproved land or development land is particularly subject to this issue.

If you take an unimproved property as security for your mortgage investment, be absolutely sure that you understand the uses permitted on the property. Don't be satisfied that the appraiser or anyone else has checked this out for you.

In most real estate appraisals there is a disclaimer from the appraiser about the legality of the use of the property. While the appraiser may provide you with a copy from the section of the land use regulating body's ordinance describing permitted uses, he probably will not come right out and say anything except that he assumes that there are no problems in this area and that he thinks the property is worth a certain amount based upon that presumption. And often it works out that assumptions as to the ability to use a property a given way will dramatically affect the appraiser's opinion of its value.

Make sure that you understand what your property can and cannot be used for. Making an assumption in this area may be utterly catastrophic, as it costs lots of money to engage the services of a professional land use consultant to attempt to change the use a given property may be entitled to enjoy.

Another aspect of the property you should document is the legality of the parcel in question. That is, is the parcel a legally-recognized unit and therefore eligible for the benefits of being improved? This may sound like a picky point, but it could be of vital concern to you. It's a simple question to ask and could save you many problems later.

Information about land use planning matters may usually be obtained from the governing body, typically at the city or county courthouse.

Access

Being able to get to and from your property is, of course, essential. Sometimes your property abuts a public roadway and the access is obvious. But always ask the title company to verify that your property does have legal access.

By way of an example, imagine a property that abuts a public highway. On the map you appear to have access, but in reality there may be access restrictions imposed by the governmental agency regulating the use of the highway. Always be sure to know that you have legal access to your property.

There are other times when you may have legal access to your property, but the physical access is from some other source. An example of this situation would be a property which abuts a county roadway but is so steep at that point that one simply could not physically get to the property. The property owner may have used another access as a practical matter, but you would want to be sure that the actual, physical access is part of the property the borrower is offering as security for your mortgage investment.

Lack of Impounds For Taxes and Insurance

It may be of particular concern to you in making a loan over an extended period of time that there be an impound account for the collection of property taxes and insurance premiums. This type of account is typical of most long-term bank mortgage loans.

To determine the amount to be collected each month, merely divide the annual estimated property taxes and insurance premium by twelve and collect this sum from the borrower each month in addition to his monthly principal and interest payment.

If you do collect this way, it is important to provide the borrower with an accounting and to offer to give him any interest earned by the sums deposited in the impound account.

You may be able to work out this type of arrangement with the collection escrow agent, although most are very particular about the way, if any, in which this type of account is handled.

The obvious risk of not impounding funds for payment of property taxes and insurance premiums is that the taxes and insurance won't be paid. You may, of course, verify the borrower's payment of these items. The only thing accomplished by the impound account is that you know the borrower is not going to be creating a bigger problem for you if he defaults on this promise to pay you.

Impounds are definitely recommended.

You should address this concern at the time you initially review the mortgage investment, as it is difficult to go back to the borrower at some point in the future and ask him to pay more each month, even though in the long run it should be all the same to him.

Strip and Waste

One of the most difficult things to protect yourself against is having the borrower destroy the property he has pledged to secure your investment. After all, he does own the property, and it's unusual for a mortgage investor to be too involved in a given property as long as payments are being made as agreed. Inspecting the property from time to time is certainly a good idea, although your inspections must be limited to a cursory drive-by unless you make a voluntary arrangement with the borrower.

In the fine print in most security instruments, such as trust deeds, mortgages and contracts of sale, there is usually a paragraph or two about what's termed “strip and waste” of the property. Strip and waste occur when the borrower allows the property to be dismantled, disfigured or somehow dramatically depreciated. Harvesting of timber is one such manifestation. Demolition is another manifestation.

About the only way possible to verify the status of the property is to take a look once in a while. In most cases this is relatively easy to do. There are cases, however, in which the borrower demolishes the interior of the property but leaves little or no sign ostensible from the exterior, where you would normally look.

Although problems of this sort don't occur too often, they can be very costly when they do. Just be aware of this possibility and do what you can to be observant when you perform whatever inspection you are able to perform.

Balloon Payments

Frequently, mortgage investments provide for the borrower to make balloon payments, and, frequently, balloon payments consist of most or all of the principal balance owed. Although many times the borrower is fully capable of making the balloon payment, you should consider just how likely it is that the borrower can make any balloon payment. The next most immediate consideration is what your position will be if the borrower doesn't make the payment as scheduled.

Among the items you need to consider is what other lending sources the borrower may have. Is the nature of the property or the borrower's credit such that another lender is likely to make a loan to the borrower for the purpose of paying you off? Is the property such that it would qualify for alternative financing if a creditworthy borrower applied for a loan using this property for security? Will you have to wait for the borrower to obtain another private loan to pay you off?

Balloon payments are not necessarily bad, but you should be comfortable with the plan to repay you before you invest in a loan calling for balloon payments.

When You Buy an Existing Mortgage

Often you will not be the initial person holding the mortgage investment. That is, the person or firm making the mortgage loan will have already closed the loan and will be collecting payments at the time you purchase the mortgage.

In these cases what you'll generally receive will be the original promissory note endorsed to your favor; a recorded assignment of the security instrument into your name; a title policy insuring your mortgage, or an endorsement to the title policy which insured the party from whom you're purchasing the mortgage investment; a mortgagee endorsement to the fire insurance policy covering the property; an assignment of the collection escrow, if any, into which the borrower's payments are being made; and a verified copied of the ledger card or other acknowledgment by the borrower of the balance owed. When you've assembled all of these items you should be in the same position as the initial mortgage investor.

Unimproved Versus Improved Property for Security

There are inherent differences between improved and unimproved property, and those differences should be considered when you invest.

Unimproved property rarely presents management problems, but it usually does not generally produce income and does have a more limited resale market. You need to keep these factors in mind when considering the relative value of unimproved land.

Improved property generally is capable of producing income, which is a benefit during the period you may have to hold it. Offsetting the benefit of income production, however, are the costs of hiring professional property management and maintaining the property. Managing the property yourself is certainly a possibility, but is recommended only for those mortgage investors who have expertise in this area. Profits are quickly eaten up by unpaid rent or unruly tenants.

In order to protect yourself in the case of taking unimproved land for security in a mortgage investment, you should consider further limiting the amount you're willing to invest relative to the property's value. If investing at a 60% loan-to-value ratio works when you invest in improved properties, you might try restricting yourself to a 50% or lower maximum loan-to-value ratio in the case of unimproved land.

Inaccurate Financial Information from Borrower

The accuracy of financial information supplied by borrowers varies considerably. It is fair to say that most financial information that borrowers supply suffers from being optimistic, sometimes overly so. Often there can be entire areas of potential or current liability overlooked.

Of course, there are many times when borrowers fail to include favorable financial information about themselves. But this condition is a problem for you, too, as you may want to use this information, at a later time, to help satisfy an obligation in your favor.

As was mentioned earlier in the section dealing with borrower creditworthiness, it is important to ask yourself whether the information the borrower supplies makes any sense to you. It is a good idea to have your accountant review the borrower's financial information.

It is not uncommon for a prospective borrower to have a mountain of glowing financial information about closely-held corporations or other ventures, and sometimes wading through what you're presented is tedious. However, just reading the material will usually give you insight into the borrower's situation.

If the borrower supplies you with financial information compiled or presented by an accountant or bookkeeper, by all means call that person and ask a question or two about the borrower and his financial affairs. If the borrower has given you authority to ask such credit questions, as he has done if he's signed a valid loan application in the FNMA form described in this publication, then you are entitled to ask these kinds of questions freely.

One thing that banks and other commercial lenders do in qualifying borrowers is to compare the financial information they are supplied by the borrowers with the borrowers' tax returns. You may do the same thing, or you may have your accountant help you. It's always a fair question to ask why a borrower's tax return doesn't match the rest of the financial information he's supplied you. Incidentally, if the answer to this question is that the borrower is hiding income from the IRS, then you may want to reconsider the borrower's loan request. If what he's telling you is truthful, then he may encounter problems with the IRS later, and that would complicate your mortgage investment.

If you do decide to compare the income the borrower tells you he has with the income his tax returns indicate, the process is usually as simple as looking at the return's adjusted gross income amount, adding to this sum any depreciation he may have claimed, and then comparing that figure to what he's telling you he's earning in the loan application form. If these numbers are substantially different, you should be comfortable with the borrower's explanation of what the cause for that difference may be.

Waiver

Waiver is a legal concept describing failure to assert your rights. If you know that the borrower is in default and you do nothing to assert your rights to collect the debt or otherwise cure the default, then you are creating a defense for the borrower.

For example, if you have a mortgage investment that calls for payments to be made monthly and the last monthly payment was made over a year ago, then it would not be too unusual for a court to decide that, since you had been so lenient in the past, the borrower should have a lengthy grace period before you could foreclose.

As a practical matter, all you have to do in most cases is reinstate “time is of the essence” language in your mortgage documents, which action is performed by providing the borrower with notice that previous acts of leniency on your part are no longer to be expected. Your attorney would typically take care of this matter when he writes a demand letter to the borrower on your behalf.

The best way to deal with problems is immediately. Procrastination usually doesn't help you and usually creates new worries for you.

Financing Schemes

While you might expect this section to tell you about financing schemes crafty borrowers might employ against you, the thrust here is different.

There are times when mortgage investors have structured their investments in ways which would seem to boilerplate their security, but which ultimately turn out to complicate or damage their ability to collect the money owed them.

Let's take the example of a knowledgeable mortgage investor who agrees to lend $25,000.00 at a higher-than-market interest rate to a borrower he knows to be a high credit risk. The borrower owns a property the mortgage investor believes to be worth $100,000.00. Just to be sure that the borrower pays the debt, however, the investor has the borrower deed the property to the investor, and the investor gives the borrower an option to buy the property back ONLY if all of the payments are made as agreed. The mortgage investor thinks that this way he won't have to foreclose if the borrower doesn't pay as agreed.

But the borrower may well be able to force the mortgage investor into court over this matter. What has happened, the borrower might say, is that the mortgage investor has really only made a loan here, creating a financing scheme intended to deny the borrower his rights to due process of law. By avoiding the foreclosure process, the borrower was never afforded the right to receive notice of any default. The borrower may well prevail in his efforts to force the mortgage investor to foreclose.

One added problem here for the mortgage investor is that he then is precluded from foreclosing non-judicially, for the borrower never executed a trust deed in favor of the mortgage investor. The effect of all of this is that the mortgage investor would then have to commence a judicial foreclosure, going through all of the legalities involved in that process, including serving all the parties, waiting for a court date, going through a sheriff's sale, and waiting through any period of redemption the borrower may have.

While this situation may or may not result, what's best is to avoid overly creative financing schemes. If the mortgage investment isn't good enough to stand on its own merits as a standard mortgage investment, it would be best to pass on this one and look for another.

Losing Original Documents

It can be vitally important for you to make sure you have control of the original documents connected with your mortgage investment.

If you have a mortgage investment involving a promissory note, remember that the promissory note is a negotiable instrument in and of itself. If you don't have it, someone else certainly may, and you have no way of knowing if it's been negotiated or compromised.

Not only is this question a good one for you to ask; it is an even better question for a borrower to ask you if you ever decide to sue the borrower for performance on the terms of the note. His defense is as simple as to say that he would have paid you but he wasn't sure that you even had the right to receive the payments. If you can't produce the original promissory note, your case is complicated greatly.

Always ask for and keep under your control or the control of the collection escrow agent any and all original documents.

Lack of Diversification

Most mortgage investors are limited, to some degree, in how much investment capital they have available. Most private mortgage investors depend, at least to some degree, on the income produced by their mortgage investments.

It seems only prudent that you limit the amount of your available capital in any particular area. Diversification is as applicable to mortgage investing as it is to other forms of investing.

For the same reasons that it seems unwise to place 90% of your capital into the stock market, it seems similarly unwise for you to put 90% of your working capital into mortgage investments.

Also, investing all of the your working capital designated for mortgage investing into one mortgage investment seems unwise. Spread your risk. If one transaction fails, it shouldn't put you out of business altogether.

Construction (Mechanics') Liens

Whenever construction materials or labor are provided to a property, the provider of the labor or materials usually has the right to perfect a lien on the property if his bill isn't paid. Such liens are called mechanics' liens.

Mechanics' liens are unique in that they frequently have the feature that they can supersede a previously-recorded security interest in real estate.

The obvious danger here is that even though you may have done your homework in getting a first trust deed on the property pledged as security for your investment, work done to the property after your trust deed was recorded could result in a lien stepping into a priority position superior to your investment. To protect your investment you may have to pay the mechanics' lien.

Danger signals for you to observe are ostensible signs of construction at the time you inspect the property. Try to stay away from these situations, as it is next to impossible for you to protect yourself fully.

When considering making investments in real estate under construction, you should strongly consider requiring the borrower to provide you with an ALTA title insurance policy. While an ALTA title policy can't guarantee you'll never have a potential claim from a workman or material supplier, your risk is reduced. You should talk with your attorney any time you're considering making a construction loan.

Participation Interests

This publication intends to deal only with so-called one-on-one mortgage investments, e.g., one mortgage investment purchased wholly by one mortgage investor.

There are, however, many opportunities to make mortgage investments in participatory interests. In this situation what happens is that one mortgage investment is divided into many smaller parts, each being offered to different mortgage investors. What you end up with is a participating, or partial interest in a given mortgage investment. Usually there is a manager designated to handle the investment. As an investor you have limited control over the management of the mortgage investment.

Such offerings are usually required to be registered with the state government. While many of these investments work out well, be particularly cautious about them, as you necessarily have limited control over your investment. And the most important questions to ask revolve around the party or parties who will be in control of the investment after you invest.

Keep in mind that as a participating investor, you'll have partners, perhaps lots of partners, none of whom it's likely you'll know or have anything in common with other than this investment. Unless you're prepared to deal with this situation, you should consider one-on-one mortgage investments more seriously than participatory mortgage investments.

Making Secondary Position Mortgage Investments

Making first position mortgage investments is far and away the best option in this type of investing. Being in first priority position brings with it a peace of mind that is nearly impossible to find in any type of secondary position mortgage investing.

However, in many instances first mortgage investments will be scarce and secondary position mortgage investments will be readily available. In some areas, the nature of the real estate market will greatly reduce the availability of good first position mortgage investments.

If you decide to consider secondary position mortgage investments, you'll need to go through all of the same procedures you'd need to have observed in making a prudent first position mortgage investment, plus the following steps, at a minimum.

The most fundamental problem with making secondary mortgage investments is that you run the risk of having to deal with the first, or superior, mortgage. If the borrower performs according to the terms of his promises to pay both you and the superior mortgage, then your difficulties will be limited. If he does not perform, then you'll have to deal with the superior mortgage in order to protect your security interest in the borrower's property.

There are only two practical methods to ensure that you won't get into a position where the superior mortgagee calls his loan due. The first method is to have the borrower's total monthly payment, including the payment due under the superior mortgage and the payment due under your mortgage, paid to a collection escrow agent. When the collection escrow agent collects the total payment, he will follow his instructions to first pay his collection fee, then pay the first mortgage, and then pay you. When you receive your monthly payment, then you'll have a reasonable degree of confidence that the first mortgage was paid also. If you don't receive your monthly payment, then you'll have reasonable confidence that the first mortgage wasn't paid, and you'd know that it's time to contact the borrower and the first mortgage holder.

The second method involves having the first mortgagee enter into an agreement with you, with the borrower's permission, to provide you with immediate notice of any default continuing more than, say, twenty days. The first mortgagee then has the responsibility to put you on notice of any default which could affect your security position in the property.

Either of these methods works, although there are mechanical difficulties possible with both methods. If you must make secondary mortgage investments, PLEASE take the time to consider the flow of payments and how you might structure those payments so you'll know if the first mortgage isn't being paid. And be sure to consult your attorney for implementing any such plan.

You'll also need to be absolutely sure that the investment you're considering is not usurious. In most states the usury statutes are more stringent with regard to secondary financing. Make sure that you don't run the risk of making a usurious loan.

And if you do make secondary mortgage investments, by all means understand all of the terms of the loans in front of you in priority. The logic here is simple: one day you may be making these payments.

Also understand that it is very possible that the first mortgagee may simply call the entire balance due and payable immediately. Unless you're prepared to deal with such a possibility, you should strongly consider making only first position mortgage investments.

It's not that all secondary mortgage investments are bad. What is true, however, is that secondary mortgage investing is far more speculative and potentially dangerous to the average mortgage investor.

Investment Cycles

Every mortgage investor should know where he and his mortgage investments fit in the overall investment cycle. This is true for many reasons, not the least of which is that the value of the property securing your investment will tend to fluctuate in accordance with the dictates of the overall investment cycle.

The cycle consists of four basic phases. Each phase has its own distinctions, some tending to be better than others with respect to real estate and mortgage investing.

Richard Band, author of *Contrary Investing* and editor of Personal Finance, a subscription newsletter for investors, expounds the following economic theory. It has been many private mortgage investors' experience that Band's business cycle theories have helped them time their mortgage investing, anticipating with some accuracy the trends which will soon affect the value of the property securing their investment, and the general direction of interest rates in the coming cycles. Band says:

> *Phase One. The cycle begins at the bottom of a recession, when the government feels it must do something to "get the economy moving again." The Federal Reserve lowers interest rates by aggressively purchasing Treasury securities from commercial banks (bidding up prices). When the Fed buys securities, it credits the banks' reserve accounts at the Fed---creating "money" out of thin air.*
>
> *Bankers aren't fools. Rather than leaving this new money on deposit with the Fed at zero interest, the commercial banks lend out as much as they think they prudently can. The money supply expands, and the economy picks up as bank customers spend their loan money. Prices of raw materials stop falling and head higher.*
>
> *Phase Two. Eventually, the economy speeds up to a point where businesses begin to make unwise investments. Interest rates still seem low enough, so businessmen decide to build factories and buy equipment "to keep up with the demand." Capital spending by business bids up loan demand and interest rates.*
>
> *Prices also start to rise more rapidly. The price increases spread from machinery and equipment down the production chain---until they hit the consumer.*
>
> *Phase Three. Now inflation is rearing its ugly head. The government moves to combat rising consumer prices by raising interest rates. The Fed gets stingier and stingier about supplying funds to the banking system. Consumers reach their personal borrowing limits and slow their spending. A recession begins, exposing all the mistaken investments by businessmen who thought the boom would go farther than it did.*
>
> *Phase Four. As the recession progresses, credit demand surges as businesses run low on cash. Consumers pay down their debts. Business lays off workers and slashes inventories to bring production into line with demand. Raw materials prices fall sharply and, after a lag, consumer prices slow their relentless climb. Finally, when the pain of recession grows too severe for the government to tolerate, the Fed eases credit and the cycle begins all over again.*

Band goes on to point out that certain types of investments tend to perform better or worse in each respective phase of the cycle.

Real estate, Band says, tends to do best in Phases Two and Three, fair in Phase One, and poorly in Phase Four. The reasons are obvious.

Income-producing investments, such as secure mortgage investments, tend to perform best in Phases One and Four, and fair in Phase Two, and poorly in Phase Three.

If you're interested in subscription information for Personal Finance, contact them at KCI Communications, Inc., 1101 King Street, Suite 400, Alexandria, VA 22314-2980

Environmental Problems

Aside from zoning, there is at least one more potential limitation on the use of property. This limitation has become increasingly important as our society has become better informed about the potential dangers to our environment and health presented by certain uses of real property.

If you should have to take back a property pledged to secure a mortgage investment, you need to know that the subject property hasn't been used in some environmentally unapproved way.

For example, if the property you took as security happens to have been used as a gas station in the past, and has underground gas tanks on the property, you may well be liable for the proper testing, repair and/or removal of the tanks.

Another example would be the case of a property used to store certain types of large electrical transformers, now known to contain environmentally unsafe PCB's. Due to the toxic nature of PCB's, you may well be required to perform a very costly and time-consuming program to the property.

Even if you are able to restore the property to an acceptable condition environmentally, you still are left with the stigma of owing a property appearing on a government list of “dangerous” properties, and you would be bound to disclose this status upon sale.

The effect of being involved with property having environmental problems is potentially disastrous. The only way to avoid such situations is to do your homework before getting involved with the property. Always make sure that you know the history of the past and present uses of any property you take for security for a mortgage investment.

Chapter Thirteen

MORTGAGE INVESTMENT CHECKLIST

Every mortgage investor should work from some sort of checklist to make sure he has asked all the basic questions and obtained all of the basic documentation attendant to his mortgage investment.

The following checklist is another tool to assist you in getting your mortgage investment off to a good start, but it isn't intended to replace good common sense and the advice of a competent attorney.

Some of the items appearing on the checklist won't apply to a particular investment. For example, you won't have a copy of a payment ledger, balance statement from the borrower, or collection escrow instructions if you're originating a new loan.

MORTGAGE INVESTMENT CHECKLIST

Borrower__________________________ Property ______________________________

Amount _________ Your Yield ___ Closing date ____________________________

_____ Loan application completed and signed

_____ Any other borrower credit information supplied

______ Credit report obtained and any questions answered

______ Read & have copies of documents noted on title report

______ Read & have copies of documents held in collection escrow

______ Reviewed payment history, if any

______ Copies of all mortgage documents for this investment

______ Will liens be paid before your funds are disbursed?

______ Proof of fire insurance coverage

______Will borrower provide you with a life insurance policy?

______ Met borrower and discussed this loan with him

______ Personally inspected the property

______ Appraisal or other value certification

______ Checked with local Realtors about the property's value

______ Photographs of the property

______ Attorney has reviewed all the documents

______ Analyzed your position if this investment fails

______ Suited to buy this investment?

______ You or collection escrow has original documents

______ Closing escrow agent has your instructions

______ Proper truth-in-lending procedures were followed

______ Security agreement & financing statement for personal property

______ Is this loan usurious?

______ Is this loan a financing scheme?

______ Borrower is not a likely bankruptcy candidate

______ Payment booklet informing borrower of any late penalties

______ Copy of this investment transaction's closing statement

______ Copies of other applicable closing statements

______ Payor statement acknowledging outstanding balance owing

______ Has the property been used in any environmentally unsound way?

_____ Other: ____

_____ Other: ____

_____ Other: ____

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KCI Communications, Inc., has allowed Richard Band's piece on investment cycles to be reprinted with permission.

Thanks to each of you for your assistance. Go Easy.

Martin Hall