THE PROFESSIONAL FINANCIAL CONSULTANT: COMMERCIAL, SBA, REAL ESTATE, AND VENTURE CAPITAL FINANCING

DELTA

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All numerical values in this course are examples subject to change. The current values may vary among different lenders depending on the type of loan and the lending institute's loan policies.

PREFACE

This course is designed to train both working CPAs and Financial Personnel to develop the knowledge and techniques required to approve and package a variety of loans and financing.

In the last decade the financial institutions of America have gone through many radical changes and periods of uncertainty. Understanding the new money markets and finding available sources of capital for investment, expansion, real estate development, and personal investment have challenged the majority of investors seeking loans.

The course focuses on the basic principles, concepts, terminology and instruments to learn and understand how to qualify a client, package a loan, and delineat the various services available in the financial community.

Chapter I identifies the skills and duties performed by a professional loan broker. Chapter II introduces the reader to the available commercial financial services, specialized terminology and financial documents and instruments used in these services. Various business financing sources are covered. Chapter III covers real estate loans and packaging of these loans along with the necessary documentation and terminology , and the instruments used to prepare a variety of real estate transactions. Chapter IV covers commercial real estate financing, analyzing income property loans, and the lending processes involved. A sample analysis for purchasing apartments, shopping centers, office-warehouses, general offices, and other types of real estate ventures are include in this chapter. Chapter V discusses in detail real estate financing and fundamentals of investing.

The glossary defines the specialized vocabulary use in loan processing. A sample number of documents are provided in the Appendix including, loan application forms, income statements, and Equal Credit Opportunity Act Notice.

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CHAPTER FOUR

INTRODUCTION

The independent financial broker is in an excellent position today due to the tremendous demand for working capital in the business community. This demand provides the loan broker with an unlimited opportunity for monetary success and personal satisfaction. Nearly all business firms need additional working capital. Lack of adequate working capital may seriously limit the true potential of many firms. The financial broker is in a position to assist these business firms in their financing needs and at the same time enjoy generous earnings for himself. You may soon become an indispensable part of your community and be known as "The Financial Expert" in your area. You are in a position to set your personal financial future at almost any level. Within a reasonable time, you may be earning more money than most of the doctors, lawyers or other professionals in your area.

Experience with borrowing procedures is the important element that enables you to justify generous fees for your services. Many businessmen cannot understand why a lending institution refuses to lend them money. They often fail to realize that banks and other lenders have specialized areas of interest and also must operate by certain principles just as do other types of business. As a professional broker, you must be willing to dedicate a certain amount of time to developing your knowledge and expertise. This will enable you to recognize viable lending opportunities.

You may start TODAY without the years and money investment necessary in most professions. As a financial broker, all that is necessary is dedication to service, truth in representations and fidelity to the ethics of membership in the great and growing fraternity of independent financial brokers.

C H A P T E R   O N E

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THE PROFESSIONAL LOAN BROKER

Learning Objectives:

After studying this chapter you will be able to:

1. Describe the role of the loan broker.
2. Outline the marketing techniques and services offered by the loan broker.
3. List the procedures to achieve financial success.
4. Qualify your clients.
5. Set your fee.
6. Implement a process for loan packaging and guaranteed income.
7. Identify the typical list of loan-packaging services.
8. Interpret the facts available in the marketplace.
9. Distinguish what lenders are look for.

It is important for the professional loan broker to understand the financial needs of his or her prospective client and the alternatives available for loan placement.

Today, there are many types of specialized loan services: receivable lenders, invoice factors, mortgage lenders, insurance investment funds, SBIC investors, private lenders, governmental SBA loans, leasing companies and many others ... all specializing in their own areas of interest. To further complicate the matter for the business firm in need of working capital, most lenders have certain minimum and/or maximum loan parameters; others prefer intermediate or long term placements; all have specialized preferences in regard to acceptable collateral, interest and pay-back arrangements.

It is readily understandable, in view of the specialization and preferences of various lenders, why the services of a professional financial consultant or loan broker are necessary for most business firms. Before the era of computers, it would often require a life-time of experience for a professional consultant to learn the preferences of an adequate number of loan sources.

WHO USES A LOAN BROKER?
Almost everyone needs additional capital at one time or another. Very few people consider themselves experts when dealing with lenders when the need for capital arises.

Thus, for the broker who knows the sources and the particular areas of interest of various lenders, he has a very valuable service to provide.

Many business firms inquiring with a broker will have diversified situations which cannot be covered by only one lender. These may be receivable financing, second mortgages, signature loans, equipment leases, construction, development, etc. In order to be of better service to more clients, and earn higher fees, it is desirable for a broker to represent many areas of financial relationships. Most brokers will specialize in commercial or consumer loans with professional brokers or financial consultants who can represent their client's needs.

HOW DOES A BROKER INTRODUCE HIS/HER SERVICES TO A CLIENT?
The broker should explain to her prospect that she is a professional financial consultant. As a professional, she has contact with many lenders in all areas of financing. The broker should inform the client that she works on a "positive results" basis, wherein, if she is able to acquire financing on the terms and arrangements acceptable to the client, she is paid a commission or fee. If no results are attained, acceptable to the client, there is a credit charge only. Further, the broker should inform the client that successful placement can be assured only after a thorough review of the client's business or financial affairs. The broker should then inquire of the client as to what financing she presently has, if any, and where she has made previous application, so that *duplication* of effort may be avoided.

Actually, the reason for requesting the information about the client's present negative financing situation is to cause her to admit that she has been unsuccessful in her personal efforts in this area. It is at this point the broker states her fee arrangements and presents her Broker Agreement for the client's signature.

The broker should inform her client that it may take several days or even several weeks to locate the best financial firm.

Even if the broker feels certain she can place a client with a financial lending source with one telephone call, she should avoid statements to this effect because there may always be complications or unexpected delays. Also, if there is a brief delay for any reason, the client will have been advised and will not expect instant results. It is always better to allow for the unexpected and win "extra points" with the client for results sooner than expected.

PROCEDURES ARE THE KEY TO FINANCIAL SUCCESS
In order to be a successful broker, it is important to follow certain procedures which are highly effective. Many brokers provide complete financial services, working with their clients every step of the way. They help the client in determining what kind of financing

he needs, how much and when he will need the funds. The financial broker might assist the client in working out a budget of personal and business expenses versus current and expected income. In this way the broker will be able to better size up the viability of the client and set a clearer picture as to which lending source would be appropriate.

As calls are received at your office from prospective borrowers, it is important that you avoid specifications as to what any lender may or may not require. A few direct questions by you should be asked along these general lines:

- How much is the borrower looking for?
- What will the funds be used for?
- What period of repayment is required?
- What collateral is available for security?
- If this is a new business start-up or expansion, how much of his own funds will the borrower be investing?
- Does the borrower have good credit?
- Will the borrower require the broker's services only for preparing a loan package, or does the borrower require loan placement as well?

The basic information will allow you to affirm whether or not your prospect generally qualifies. After the validity of the applicant has been established, you may then arrange an appointment to review your applicant's requirements. If you believe your applicant to be credit worthy, your presentation is somewhat as follows: "As a professional financial broker, my commissions are based on successful placement. If I am unable to locate a lender who will accept your application on terms and conditions suitable to you, there is no commission payable to me. In the event that I am able to arrange a successful placement with a lender suitable to you, I have earned my commission. Your only cost will have been a one-time credit fee of $50 payable to the broker. This will cover the costs of a complete credit check without the problem of a number of needless 'inquiries' on your report."

QUALIFY YOUR CLIENTS

Successful brokers are good at selecting clients who will be approved by a lender. They have to feel completely satisfied with the answers to several questions about the client and his loan request. In this qualification process the broker will determine what his charges will be and to which lender he will submit the applicant.

Novices in the financial brokerage business are sometimes as bewildered as their clients at the time it takes to get a loan from concept to execution. Each kind of loan has its own rhythm and time frame. You will come out ahead if:

(a) you know what to expect, and
(b) you tell your client what you know.

Take a tip from the professionals in the business and give your clients the facts from the beginning. This is a part of your service to them. They expect you to be completely knowledgeable about the business of raising money. Don't be afraid to assume the teacher's mantle. It will be good for your image and for their piece of mind.

One technique for giving straight facts to your clients is personal contact. This is vital, or otherwise one of you may honestly get it wrong. There is no substitute for getting one-on-one to explain the whys and wherefores of borrowing money.

If you give your clients straightforward information about how financing works, the client-consumer will be able to decide intelligently whether he can afford your services. Further, you will display the right public image for your business. Most important, if you do get the commission, you won't be nickel-and-dimed with, "When do I get my loan money?" 20 times a day.

Following is a chart that gives you an idea of the time it generally takes for various kinds of financing to be approved. Individual circumstances vary, but you can use this as a guide. *Note:* All numerical values in this chart and throughout the course are examples subject to change. The current values may vary among different lenders depending on the type of loan and the lending institute's loan policies.

Type of Loan	Days to Approval	Days to Closing
1st Mortgage: Commercial Buildings and Major Apartment Complexes	30-60	90
1st Mortgage: Commercial Property under $150,000	30	30
1st Mortgage: House	30	30
2nd Mortgage: Commercial Buildings and Major Apartment Complexes; Commercial Property under $150,000	30	30
2nd Mortgage: House	10	7
Equipment Financing (under $1 Million)	15	10
Accounts Receivable Financing	21	10

SETTING YOUR FEE

Processing fees are charged by a financial broker for his services. Services include filling out an application, preparing a financial statement, preparing a summary of the loan proposal, doing all the paperwork and legwork, making telephone calls, checking all documents and any other jobs necessary to process the transaction.

When a borrower calls your office, one of the first questions he will ask is, "What do you charge to arrange a loan?" This question can best be answered after the broker has qualified the clients request as outlined above.

Determine the size of loan he seeks, the purpose, and what services are required of you and it will be easy for you to set your fee.

In setting fees you must, however, be aware of certain important factors about your lenders:

1. There are certain instances where a lender's banking arrangements require them to include a fee as part of their commitment. The possibility of a conflicting fee structure or the total fees significantly affecting overall costs may hamper the lender's ability to successfully complete the financing.

2. Because a lender is "on the hook" for the life of the loan, they may not allow a client to become disgruntled over excessive fees at the inception of the loan, then only to become a "bad debt" a year or two later.

However, most lenders will honor any agreement that you may have with your prospect if you have it in writing and if it is allowable within the structure of their arrangement. You must include a signed copy of your fee arrangement at the time of your initial submission.

Broker's loan placement fees range from 0.5 percent to 10 percent and go as high as 20 percent! But fees like this are rarely paid because the borrower may go elsewhere to get his loan!

Some brokers start with a 5 percent minimum on a $10,000 loan. Others charge a flat fee regardless of the size of the loan. Your policy will be established through experience. We have found a charge of 5 percent or $750 minimum was most typical, with larger loans in the $75,000 range being charged 3 percent. A possible schedule might look like the following chart. *Note:* All numerical values in this course are examples subject to change. The current values may vary among different lenders depending on the type of loan and the lending institute's loan policies.

COMMISSION SCHEDULE - LOAN PLACEMENT FEES

Loan Amount ($)	Your Fee (%)	Your Commission ($)
5,000,000 +	0.5	25,000
2,000,000	1.0	20,000
1,000,000	1.5	15,000
500,000	2.0	10,000
100,000	3.0	3,000
50,000	4.0	2,000
30,000 & under	5.0 - 10.0	750 minimum

Most brokers charge according to the size of the loan and the type of loan as well. If it is a solid business loan with good collateral, the fee is set lower. But if it looks like an approvable loan with high risk, charge 10 percent even for larger loans to compensate for the extra difficulty - but keep the lender's requirements in mind!

You are charging according to the amount of work needed to place the loan, and you are also taking a higher fee because it may be less likely you will even find a loan, ending with zero commission. This happens frequently, and you have to charge enough on the loans that go through to make up for wasted time on those that don't.

To clarify, we are not talking about front money. Most lenders will not even work with any brokers who charge front money. Front money creates too many problems for all concerned - especially if the loan cannot be completed. As an independent professional you must always keep ethics in mind if you are to build your reputation and establish positive client recognition in your community.

LOAN PACKAGING GUARANTEED - INCOME

The bread and butter of a broker's business can be packaging loan applications. After a borrower calls or sends a letter in response to an advertisement or direct-mail piece, the broker asks for the basic information about his business or personal finances. Some brokers prefer to visit the borrower in his place of business, but time is a very serious commodity, and it is preferable to see the client in your office.

If the borrower is seeking assistance in preparing a loan request, you can earn a fee for your time and expertise in preparing his loan request. Then, if he wishes to use your services for loan placement as well, you can elect to waive the packaging fee upon successful funding or you can make separate arrangements for payment.

TYPICAL LIST OF LOAN-PACKAGING SERVICES
(Once again, your experience will dictate any changes).

1. Prepare loan application.
2. Prepare summary of loan request showing:
   (a) amount
   (b) purpose
   (c) collateral
   (d) other pertinent information.
3. Prepare personal financial statement.
4. Prepare business financial statement.
5. Prepare personal budget.
6. Prepare business income and expense statement.
7. Photocopy 2 sets for client.
8. Bind in a professional-looking package.

A financial broker gains respect from his clients by showing his experience and knowledge in every phase of financing. He should know the current lending rates and investing climate as well as the needs of the various lending organizations and individuals making the decisions. And, just as important, he should know what business proposals are viable money-makers that will pass the critical inspection of the potential lender. This knowledge and the ability to package and sell a loan proposal greatly improve the borrower's chances of getting a good loan.

FACTS OF THE MARKET PLACE
Most of the borrowers who come to you don't realize that they won't be able to dictate the terms of their loan. They already may be convinced that they have a great idea for a business, and they want to come in with little or no money of their own. They may also think that they can still arrange money at 7, 9 or 11 percent interest!

These people have to be screened. Don't waste time trying to find them a loan only to have them refuse it because of the rate or terms. Tell them to try their local sources first. The banks and other people they go to will quickly educate them about the difficulties in getting a loan and the high rates necessary to borrow money.

They will soon realize that the lender calls the shots. The Golden Rule of Financing states: "He who has the Gold makes the Rules!" Use this to your advantage. Know your lenders and the rates and terms available at all times. Be prepared to explain in a businesslike manner to your client exactly what he can expect so you will not ultimately be wasting your time in his behalf.

WHAT LENDERS LOOK FOR

Lenders are in the money business. Lenders do not want to be in the real estate business, the equipment sales business, nor the asset liquidation business. They want to invest their money in good, safe proposals where they'll get a fair return on their dollars, as well as get their investment capital back. This may be a bit oversimplified, but it is an important perspective to keep in mind.

Banks and institutions use a set of criteria to determine whether or not to loan money to businesses and individuals - developed over decades, they are a standard measurement of good risk. Whether the request is a small loan, a mega-dollar request, a personal loan, or a business loan, a lender will look at your borrower within these general guidelines:

- Stability
- Business experience
- Purpose of the loan
- Collateral
- Cash flow
- Credit history
- Secondary sources of repayment

FIVE C'S OF CREDIT

The five C's of credit is five elements used by lenders in evaluating a borrower's credit application.

They are:

- Character (willingness to pay)
- Capacity (cash flow)
- Capital (wealth)
- Collateral (security)
- Conditions (economic conditions)

Character reflects a customer's integrity, and reliability in meeting financial obligations. The borrower's credit history indicates how reliable the borrower is in paying bills on time.

Capacity looks at a borrower's earning power and/or cash flow. Capital analyzes a borrower's balance sheet (assets and liabilities revealing whether net worth is positive or negative). Collateral refers to assets that can be secured and liquidated by the lender if a loan is not repaid. Finally, conditions mean economic conditions at the time of the loan and a borrower's vulnerability to business downturn or credit crunch. When much money is available, especially at low interest rates, it is much easier to obtain credit, whereas in a credit crunch, many applicants would be rejected who would normally have been approved for credit.

Once the five C's are analyzed, a borrower is assigned to a credit rating category, which will determine the default risk premium for the borrower. Generally, the higher a customer's credit risk, the higher the loan rate.

C H A P T E R   T W O

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COMMERCIAL FINANCE

Learning Objectives:

After studying this chapter you will be able to:

1. Outline the process for factoring accounts.
2. Facilitate the use of accounts receivable for financing.
3. Utilize inventory financing.
4. Justify the use of equipment financing and equipment leasing.
5. Select and prioritize your business financing.
6. Apply for Small Business Administration (SBA) loans.
7. Arrange for venture capital financing.
8. Work a loan online.
9. Raise equity and venture capital online.

Commercial finance means money for business. Every business needs cash, whether for working capital, expansion, the acquisition of machinery and equipment, or consolidation of debts. If a business is satisfied with its current financing relationships, it is unlikely that you will be able to provide assistance. However, if your business contacts are unsatisfied with their current banking or financing relationships, your expertise as a Financial Broker/Finder is of great value.

Commercial finance can be divided into two main categories: *unsecured* or *secure*d.

UNSECURED DEBT

Unsecured debt may come from the banking community and is available only to those most creditworthy borrowers. Unsecured debt usually takes the form of a short-term line of credit. Another source of unsecured funds is the investment community. Many companies enjoy the availability of cash through the sale of commercial paper. The third source of unsecured financing is the equity market. Businesses may bring in investors who purchase a part of the business or make loans with stock options.

SECURED DEBT

Secured debt is the technique of using *collateral* to support a loan request. This form of financing is available from some banks, however, the majority of asset-based lending is handled through commercial finance companies scattered across the United States.

So, in common parlance today, the term "Commercial Finance" (or "Asset-Based Lending") has come to mean the provision of revolving lines of credit based upon and secured by an asset base consisting of either or both of inventory and accounts receivable with, on occasion, the additional involvement of real estate, machinery and equipment (either as additional collateral or as the subject of an adjunct term loan).

Your services can make the difference between a company succeeding or failing. You will be able to help your contacts meet lending institutions which are very interested in making loans - not just wasting time. The fact is, most people don't have access to the right lending institutions. There are lenders in other states, for example, that your prospect may never even consider as a possible funding source. Further more, there are so many different lenders with specialized financing activities and requirements, it is unlikely a borrower could find the right lender at the right price in time without assistance. An experienced financial broker or finder has the relationships that have proven their ability to perform. Therefore, your customer saves time and actually *gets the loan*. The successful financial broker or finder knows how to avoid costly wheel-spinning by identifying the good deals. In commercial finance, the "good deals" are the deals that get *done*.

There is no shortage of people who would like to borrow money, but not everyone can qualify. By getting a clear understanding of your customer's needs and qualifications, you can quickly respond with a list of options realistically available. If your customer can benefit from your lender's offer, the right lender will make the direct contact with the principals without delay. Your job as a professional financial broker or finder is to make sure that your borrower and a responsible lending source meet, in person, as soon as possible.

WHO IS YOUR CUSTOMER?

Commercial finance customers borrow requests from as low as $25,000 to many millions. The average loan, according to the National Commercial Finance Association, is $750,000. Borrowers need funds for working capital in their business, for payroll, accounts payable, the purchase of inventory or equipment or investment in new opportunities. Also, commercial finance customers may have experienced recent losses and would like to consolidate existing debt. Annual sales for commercial finance customers could be as low as $500,000 per year. The average sale for commercial finance customers is $20 million per year. There are no specific net worth requirements. Borrowers may even have a negative net worth if there are assets to support the loan request.

The types of companies that use commercial finance are primarily manufacturers, wholesalers, distributors, and service businesses. Retailers may use commercial finance techniques on a limited basis.

PRELIMINARY CLIENT ANALYSIS

In an effort to maximize success and minimize wheel-spinning, it is important to get a clear understanding of your client's loan request prior to processing. There are four basic questions that must be answered in the initial investigation:

1. How much does your client want to borrow? This question must be answered specifically. An unclear loan amount is an indication of a poorly planned loan request.
2. How are the funds to be used and what is the benefit to the borrower? Get a clear understanding of how the funds are to be distributed, *i.e.* specific equipment, purchase of inventory, increasing sales force or advertising expense. Next, determine how your client will benefit from the use of the funds, i.e. additional future profits or additional time to work-out historic difficulty.
3. What is the collateral to be pledged?
4. What is the method of repayment? *i.e.* profits over a long term, a restructuring of debt or the sale of assets.

COMMERCIAL FINANCE SERVICES

FACTORING

Factoring is defined as the purchase of accounts receivable on a non-recourse, notification basis. Factoring frees client management from costly credit and collection activities. The factor assumes the credit risk on credit-approved sales; clients' customers are notified to pay the factor directly. Many of today's lending factors trace their origins to the 1800's, the time of industrial growth, when the factoring industry dealt almost exclusively with textile companies. The textile and related industries still account for the majority of factored sales, but factors have now expanded their horizons to other industries, including in recent years toys, furniture, carpets, electronics, plastics, and home furnishings. Many factoring companies market their services directly to businesses. Certain industries, like garment manufacturing, gravitate toward factoring, which is selling the accounts receivable, rather than borrowing against their value.

Factoring and commercial finance have long been recognized by the business community as methods of financing for companies that are seeking an alternative to traditional banking. However, the modern factoring and commercial finance company is more than just a source of funds. It actually functions as a financial service center, where in addition to financing, clients may obtain credit, collection, bookkeeping, data processing and counseling services.

Although larger factoring relationships, in excess of $100,000, are generally on a non-recourse basis, a new type of factoring has developed over the years for the smaller factoring account. These relationships are often structured in a fashion that requires the client to repurchase accounts receivable which are older than 60 days. Not only does recourse factoring require the repurchase of an account, but it also may be cross collateralized by additional equities in a business. Furthermore, personal guarantees of the principals may be required. These guarantees, too, may be secured by personal assets including a residence or other personally owned assets. The modern factor offers four basic factoring plans which may be adapted to individual client situations:

- Conventional or standard factoring
- Maturity factoring
- Maturity factoring with an assignment of equity
- Import factoring

CONVENTIONAL FACTORING

Conventional or standard factoring is the most common plan. A client sells its accounts receivable to a factor without recourse, in return for cash paid monthly on a hypothetical average maturity date. This plan is usually recommended for companies whose cash requirements exceed the amount they can borrow from a bank on an unsecured basis. The sale of receivables accelerates cash flow by eliminating the time lag between the client's shipment of merchandise and the customer's payment of the invoice.

Customers are notified to pay the factor directly; the factor assumes the credit risk and handles all details of credit checking, accounts receivable bookkeeping and collection. As part of this plan, cash advances against receivables are made to the client before the maturity date, with interest calculated to the maturity date.

MATURITY FACTORING

In maturity factoring, the client is more interested in the supportive services of a factor than in financing. Maturity factoring resembles conventional factoring but is used by companies with adequate working capital which can borrow funds as needed directly from a bank on an unsecured basis. Accounts receivable are sold to the factor on a non-recourse basis, with payment to the client based on the average maturity date of the client's invoices. The factor's guarantee of purchased receivables usually strengthens the client's borrowing position with its bank because repayment of bank loans can be planned in relation to scheduled factor maturity payments.

The factor assumes the credit risk and provides receivables bookkeeping and collection services, but cash advances against receivables are not made.

MATURITY FACTORING WITH EQUITY

Maturity factoring with an assignment of equity combines the features of conventional and maturity factoring. It is designed for the client who wishes to maintain a borrowing relationship with its regular bank, while obtaining funds in excess of its normal unsecured bank line. The client assigns the equity in its credit balance at the factor to its bank and borrows funds as needed from the bank at bank rates. The factor pays the client's matured balances directly to the bank;

the bank then reduces the client's loan balance by the amount paid. Again, the factor assumes the credit risk and provides receivables bookkeeping and collection services.

IMPORT FACTORING

With import factoring, the client again receives credit risk protection, accounts receivable bookkeeping and collection services. In addition, this type of factoring provides for interim financing of imported merchandise on the basis of trust receipts signifying foreign shipment of goods. Client accounts receivable are turned over to the factor to repay any funds advanced for freight, duty or other expenses. Bonded warehouse loans may be obtained, as well as letter of credit financing in amounts higher than are normally available from commercial banks.

For basic factoring services, each client pays a commission ranging from .75% to 1.5% of factored sales. If funds are advanced before the scheduled maturity date, there is an additional interest charge on advances at a rate of 2 1/2% to 3% above the New York commercial banks' prime rate. (However, there are no requirements for compensating balances as there may be such requirements for other commercial finance loan types.) Individual client rates are determined by the factor after considering all relevant facts, such as the financial strength of the company, the average invoice size and the projected sales volume.

In each of the four plans, factoring frees client management from the costly, time-consuming burden of credit and collection activities, permitting more executive time to be devoted to profitable selling for the company. The accelerated, dependable cash flow provided by factoring also enables clients to increase working capital turnover, to offer more competitive terms of sale, to take advantage of trade discounts or unexpected purchasing opportunities, and to modernize production facilities when necessary.

ACCOUNTS RECEIVABLE FINANCING

Asset-based loans use a company's accounts receivable, inventory and equipment as collateral. Accounts receivable financing is a form of asset- based lending. Account receivable is similar to factoring in the flexibility of available financing plans. It differs from factoring in the method of handling accounts receivable, the services provided, and the range of collateral which may be used to secure client loans. The typical user is a company that is undercapitalized, going through financial trouble – maybe losing money or growing too fast – and its cash flow can't keep up with its money needs. *Note:* Companies that can qualify for bank financing should use that. The costs of accounts receivable financing varies with the amount of receivables. With the largest companies, the deals approach bank rates. On average, the loan interest is variable, prime rate plus 1 percent to 3 percent on the average daily loan balance. But rates can range from 11 percent to 25 percent, depending on how risky the borrower's situation is.

In factoring, approved accounts receivable are *sold* to the factor by its clients. In accounts receivable financing, clients' accounts receivable are *pledged or assigned* to the lender as security for short-term borrowings. Assignment of receivables is made with recourse to the clients and without notification to the client's customers. Clients maintain their own credit, collection and bookkeeping departments but forward customer payments to the lender to reduce outstanding loans.

Conventional accounts receivable financing provides for up to an 80% advance against "eligible" accounts receivable. Eligible accounts receivable are those that are not considered to be too delinquent in the eyes of the lender. Normally, any receivable older than 60-90 days is considered ineligible.

As accounts receivable are created, new availability for borrowing is created. As accounts receivable are collected, the loan balance is reduced accordingly. Although an accounts receivable financing relationship may be non-recourse, the lender will continue to aggressively analyze the credit worthiness of existing and potential account debtors. A lender will be concerned about any possible concentration in the receivables to any single account debtor. A standard rule of thumb in the industry provides that no account should be greater than 20% of the total outstanding accounts receivable. If an account is greater than 20%, the lender may determine that any amount over 20% will be considered ineligible.

If accounts receivable are not sufficient to secure the amount of financing required, other collateral, such as inventory or machinery and equipment, may be used as additional security. For example, a comprehensive finance plan might include percentage advances against the value of pledged inventory, or a chattel mortgage on income-producing equipment might be arranged.

In an attempt to maximize your effort, it is important to be aware of several obstacles that confront accounts receivable financing. The most important issue is to determine if an account receivable actually exits. An account receivable which is eligible for financing must be free from off-sets or claims or third parties. If a client is both buying and selling from a third party, the account receivable may be invalidated as a result of debt from the account debtor to the client. In other words, if a client has an account receivable for $50,000 from an account debtor, but also has an account payable to that same company, the receivable is off-set by the debt.

Another obstacle is *progress billing*. Many contracting firms use the practice of billing for work completed on an on-going basis, under the terms of a contractual agreement. Although a contractor may believe that they have an account receivable for work that has been partially completed and billed, the accounts receivable lender will be concerned about possible litigation if the entire job is not completed to the satisfaction of the parties involved.

Another issue of concern to the lender in accounts receivable financing is the question of *guaranteed sales*. Often, a client will sell to an account debtor and promise (either in writing or verbally) that the inventory which is unsold by the account debtor will be repurchased by the client. This obviously invalidates an account receivable.

RATE

Because of both the high risk involved in commercial financing and the lender's cost of processing collateral, the interest rate on a finance loan will usually range from 5% to 7% above the major commercial banks' prime rate. Again, interest is charged only on funds actually used, and there are usually no compensating balancing requirements.

A client's interest rate may be somewhat lower if the client qualifies for a *participating loan*. This type of loan has recently grown in frequency of use and importance as its advantages to both banks and borrowers have become better understood and appreciated. There are times when a commercial bank would like to keep an established lending relationship with a client but would also like to limit the amount of money committed to a loan as well as the risk involved. In such a situation the bank turns over the administration of the loan to a finance company, which then lends directly to the client against accounts receivable on the normal non-notification basis with recourse to the borrower. The finance company sells an interest in the loan to the commercial bank but continues to handle the details of the loan directly with the client.

For the commercial bank, a lending relationship with a valued client is retained, the bank is free of restrictions resulting from tight money conditions, and it may now be possible to extend loans beyond the normal credit limits of the borrowing company. For the borrower more working capital can be obtained than would normally be available directly from the bank, and usually at a lower interest rate than would be paid for funds supplied entirely by the finance company.

Clearly, a factoring and commercial finance organization offers potential clients not only flexible methods of financing but also valuable services. Companies needing credit, collection, bookkeeping and counseling services, in addition to financing, choose factoring. Companies needing only financing and counseling services choose commercial finance.

INVENTORY FINANCING

Inventory financing is almost always transacted in conjunction with accounts receivable financing. A lender will advance as high as 70% of the cost of inventory; however, more often the advance is 25% to 30%. The advance rate is dependent upon the type of inventory. Raw steel will have a far greater value and advance rate than work-in-process. Partially fabricated merchandise has less value because it requires additional expenditures to convert it to a finished product. Many lending institutions will increase the advance on inventory if the inventory is controlled by the lender. This can be performed by placing the inventory in a warehouse or using a field warehousing program.

Field warehousing is a technique wherein the inventory at a client's facility is placed under the control of a third party. This third party is bonded and hires an employee of the client to monitor the inventory for the benefit of the warehousing company. This technique, although more costly than a non-controlled inventory loan can provide for a maximum advance rate.

As inventory is sold, it is generally converted into an account receivable. If a client receives cash for the inventory, it should be immediately applied to reduce the inventory loan.

EQUIPMENT FINANCING

Equipment financing is composed of two categories:

1. The purchase of new equipment;
2. The refinancing of existing equipment.

The purchasing of equipment in commercial finance is almost identical to the purchase of an automobile where financing is involved. Generally, a loan is structured for a period from 3 to 5 years. If the equipment is income-producing, a commercial finance lender will usually include the income-producing quality of the equipment, normally 20%, in the cash flow analysis. Generally, lenders require a 10-20% down payment as part of the transaction. Although the cost of new or used equipment is generally the guideline for the amount of down payment, some lenders may require an appraisal to verify that the purchase price is a reasonable one. For used equipment not purchased from a major dealer, there is a 60% maximum advance.

If a client is seeking working capital, he may be able to leverage his existing equipment from a commercial finance lender. An advance on existing equipment will depend upon appraisal made by either the lending institution or an outside appraiser. It is wise not to appraise existing equipment prior to meeting with a lender. The danger exists that a lender may not accept the appraisal already made and the client could suffer unnecessary expenses. Refinanced equipment loans may also have a term from 3 to 5 years.

Whether the client is requesting purchase-money for equipment or the refinancing of equipment for working capital, commercial finance lenders will be concerned about several obstacles.

The first obstacle is "technological obsolescence." This term applies to any piece of equipment that is subject to rapid depreciation as a result of our advancing technology. Computers are a good example. Computers may be technologically obsolete even before they are sold. This rapid process of depreciation renders the equipment less valuable. Equipment that holds its value in a normal economy includes: metal-working machine tools, printing equipment, heavy construction equipment, plastic extrusion machines and some wood-working equipment.

Equipment that is considered not to hold its value includes that for restaurants, hi-tech electronics, recording and film-making.

Although collateral may be undesirable from a commercial finance lending standpoint, that does not render it useless. Often, an equipment loan can be made by pledging additional collateral to support the value.

EQUIPMENT LEASING

During the past twenty years, equipment leasing has become one of the fastest growing methods of capital financing in the United States. The increased popularity of leasing is attributable primarily to tax benefits and case flow advantages, although other less obvious factors have played an important role as well. Given the present state of the economy, equipment leasing should be expected to continue to provide an attractive financing alternative in the years ahead. Whether a company is a small proprietorship or a Fortune 500 giant, it will probably lease equipment.

YOUR MARKET

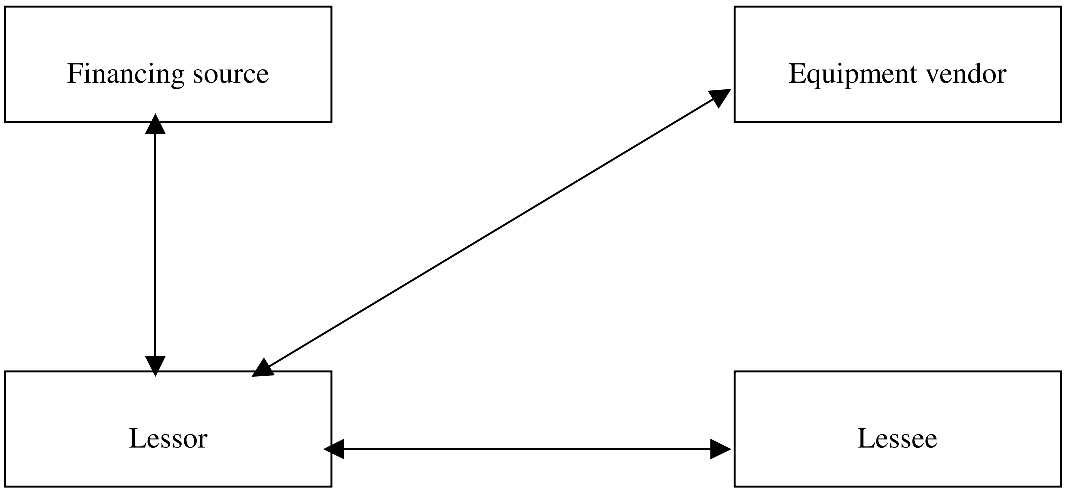
You will be able to arrange leases for manufacturers, retailers, jobbers, dealers, professional services, *etc.*; for rolling stock, fixtures, farm implements, oil rigs, computers, electronic equipment, office equipment, heavy equipment, aircraft, ships, or almost any other item requiring substantial capital expenditure and at the same time enjoy generous earnings for yourself.

OVERVIEW OF THE LEASING PROCESS

A typical lease (usually called a single-investor lease) involves four parties (Figure 1).

FIGURE 1

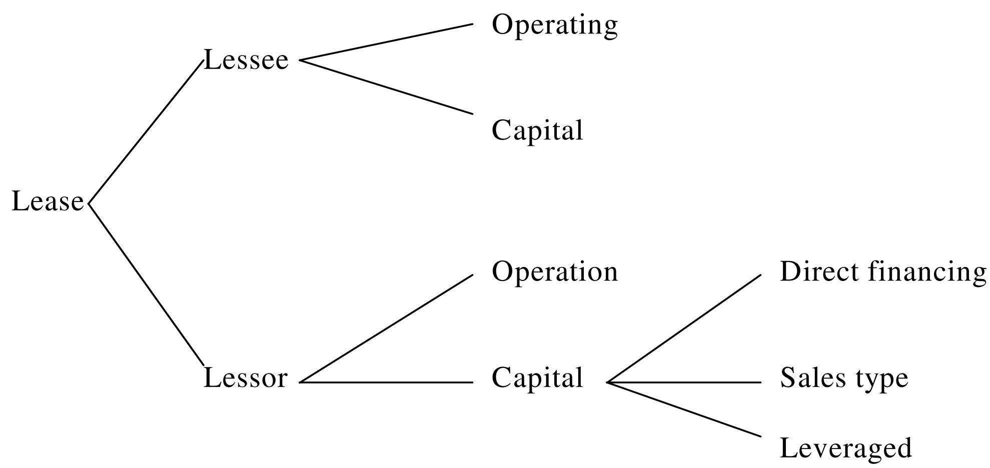
A TYPICAL LEASE



Simple analysis suggests that, if the lessor retains title to the asset in question, the transaction is a rental or lease. If, however, the lessee eventually ends up with the asset, the lease in question begins to look like some kind of sale from the lessor to the lessee. In budgetary parlance the transaction is either analyzed as part of the operating budget (if an operating lease) or the capital budget (if a capital lease). Because these two budgets are frequently prepared by different persons, require vastly differing analytical approaches, and dramatically alter balance sheet and income statement presentation, we must become skilled captains of the leasing ship as it sails the financial waters.

FIGURE 2

LEASE ANALYSIS



LEASING LANGUAGE
One element that makes leasing seem more complicated than it is, is the terminology used. The leasing industry adopted its own unique language in order to comply with both the Financial Accounting Standards Board (FASB) and IRS requirements. The following is a glossary of the most common terms used in leasing.

Advance Rental
The rental payments required to be paid at the beginning of a lease. Usually, much less than a down payment.

Aggregate Rentals
The sum of rental payments.

Capitalized Cost
Actual purchase price plus other costs incurred by lessor in obtaining the equipment.

Capital Lease
A full payout lease.

Fixed Payment Lease
A set payment amount that remains constant during the term of the lease.

Fixed Rate
Leasing charges which do not vary during the term of the lease.

Full Payout Lease
The total of rental payments equals the cost of equipment plus the lessor's overhead.

Lease Term

Period during which lessee is entitled to the use of the equipment.

Lessee

The customer who uses and makes the rental payments on the equipment.

Lessor

The company who owns the equipment and receives the rental payments.

Loss Payable Clause

A clause usually included in an insurance policy allowing loss payment to be paid to someone other than insured, i.e. the lessor.

Lease

All costs in regard to the use of equipment including taxes, insurance, maintenance, *etc*. are paid by lessee.

Option Clause

A clause in lease that allows lessee to purchase equipment at a predetermined price.

Rentals

Monies (payments) paid by lessee to lessor for use of equipment.

Rental Tax

A tax based on the rental payment rather than a sales tax on the total equipment price.

Residual

Special option included in lease which lets the lessee purchase equipment at the end of the lease, usually a set percentage and sometimes called a "buyout" agreement.

Title

Document used as evidence of ownership which remains in the name of lessor until final sale and settlement.

TYPES OF LEASE SOURCES

Lessors

- Financial institutions (banks, savings & loans, finance companies, etc.)
- Captives (vendors and banks)
- Independents

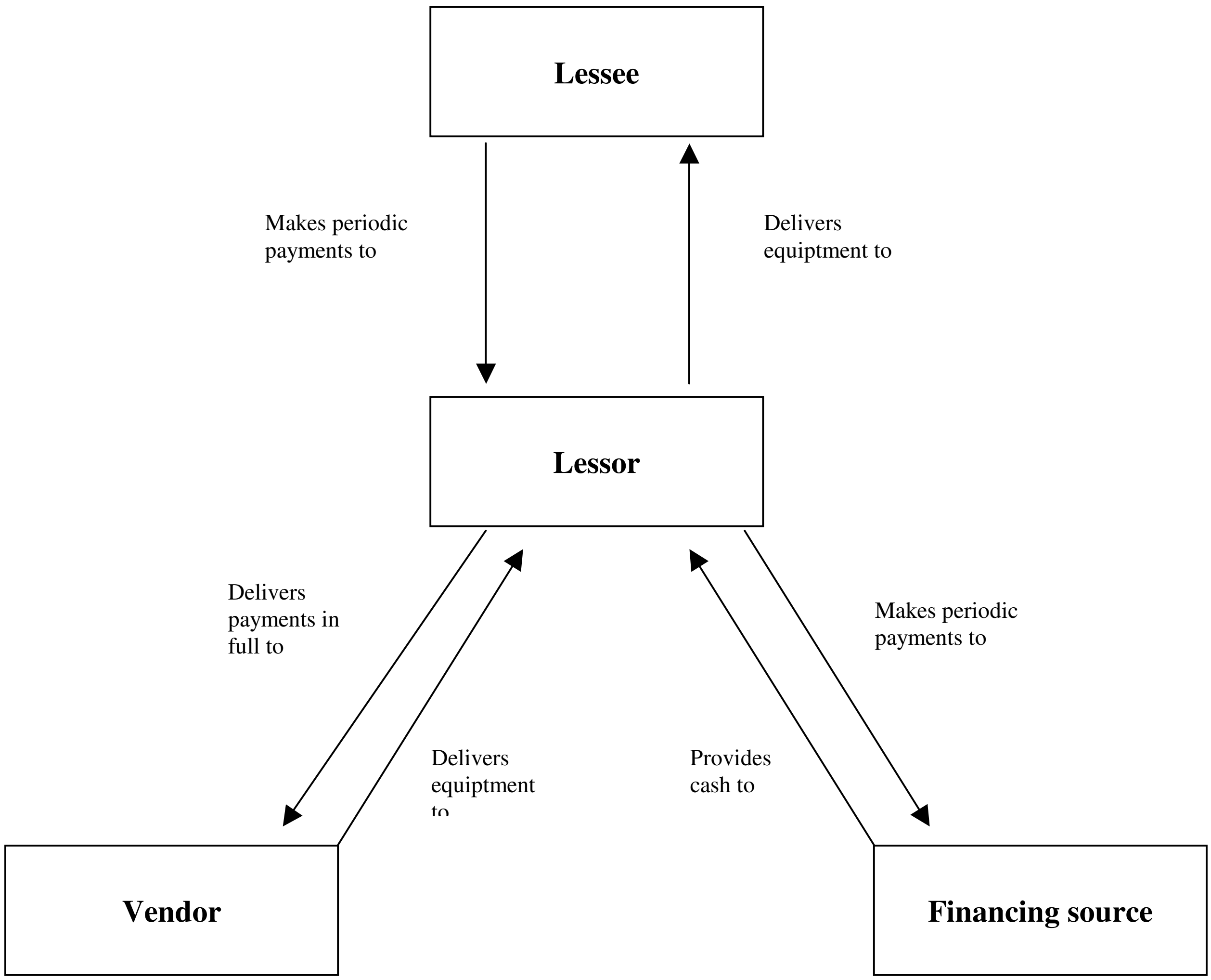
In the United States, independent leasing companies have traditionally held the biggest share of the leasing business. Banks entered the game in a big way in the late 1970s and early 1980s and built large portfolios, many of which were liquidated in the late 1980s and early 1990s as they experienced operating and regulatory difficulties. The current trend in the industry is the awakening and substantial growth of the "vendor" sector, who have discovered that leasing can be a tremendous marketing tool for expansion as well as a profit center.

Many entities have joined the leasing game. They include:

Independent leasing companies. This is the traditional type of lease provider who originally would lease anything to anyone (Figure 3). Increased competitive pressure has forced many of these companies to concentrate in niches, such as telecommunications or automobiles. The largest such player is Comdisco, an international participant in Chicago that specialized originally in the used IBM market.

FIGURE 3

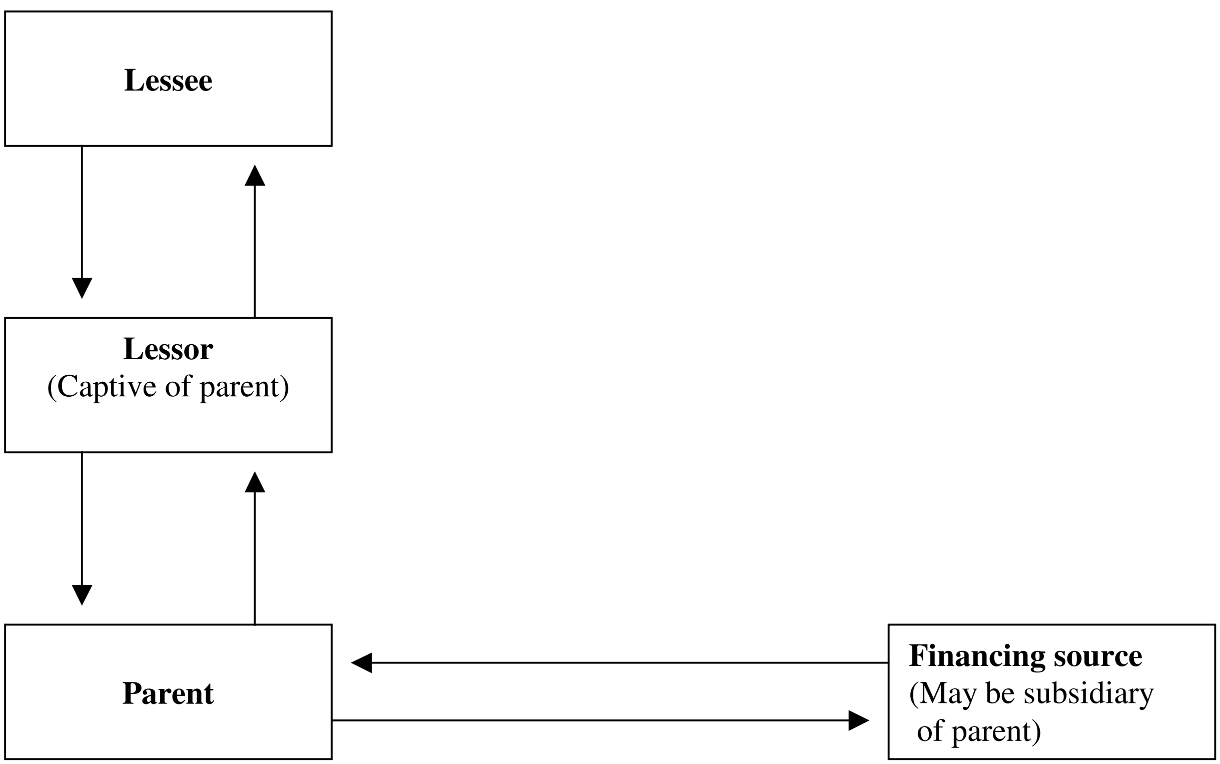
TYPICAL INDEPENDENT LEASE COMPANY TRANSACTION (THIRD-PARTY LEASE)


Lessee
Makes periodic payments to
Delivers equiptment to
Lessor
Delivers payments in full to
Delivers equiptment to
Provides cash to
Makes periodic payments to
Vendor
Financing source

Captives. This is the hot market of the early 1990s. Because they operate under the scrutiny of a parent, they are usually not as nimble and flexible as an independent, but they have tremendous clout because of this same parent relationship (Figure 4). Examples include GECC (General Electric) and ICC (IBM).

FIGURE 4

CAPTIVE LEASING COMPANY



Brokers. During the frothy and profitable "go-go" years, many experienced leasing professionals discovered they could function as financial intermediaries, bringing together the necessary participants, thus functioning as a manager. Brokers come and go, but typically prefer to manage bigger deals, such as jumbo jets and large computer mainframes.

Banks. In the United States, banks entered the leasing game after it was somewhat mature. By way of contrast, banks in Europe and the Middle East were primary developers, and hence currently enjoy a much larger market presence in those geographical regions. U.S. banks dramatically altered their position in the leasing arena during the last few years because of large credit losses and subsequent government tightening of regulations.

Insurance Companies. Two approaches have been taken in this industry. Several large firms, such as Metropolitan Life Insurance, formed leasing subsidiaries and aggressively funded deals. Others are content to purchase large individual leases or portfolios on the secondary market, much like the home mortgage market.

Finance Companies. Many of these players jumped into the arena, especially in the area of consumer leasing. Because they already were active here, they expanded their horizon to include operating leases and thereby assumed a risk they were not experienced to handle (residual risk).

Pension Funds. Usually these funds serve as a reservoir of lease portfolios and purchased leases from others. Needless to say, many questionable and some worthless papers found its way into the hands of these typically inexperienced participants.

Lease Pools. Functioning much like a mutual fund, many lease pools sold "shares" in future expected values to wealthy individuals and companies.

TYPES OF LEASES

Most equipment leases can be described as either *full payout* or *partial payout*.

In a *full payout* lease, the lessor expects to receive, by the expiration of the lease, an amount equal to the purchase price of the equipment plus a reasonable profit for the use of the lessor's money. Virtually all leases intended as security, and some true leases, will qualify as "full payout" (also known as "net" or "finance" leases). On the other hand, many true leases are more properly classified as "operating" or *partial payout* leases, i.e., the lessor is ultimately required to look to the residual value of the equipment in order to realize the full benefit of its investment.

A *leveraged lease* is a form of tax-oriented true lease where a substantial portion of the purchase price of the equipment is provided on a long-term basis by a third party creditor. When large sums of money are involved, it is not uncommon for multiple lessors or creditors to participate in the transaction. For ease of administration, trustees may be appointed to represent the interests of the lessors or the creditors.

From the view point of a bank or other financial institution, an equipment leasing transaction may either involve a "direct lease" or an "indirect lease." As used herein, the term "direct lease" is intended to refer to a two-party transaction where the bank or other institution is the original (*i.e.*, "direct") lessor of the equipment. The term "indirect leasing" is a shorthand reference to the transactions where the financial institution is not the original lessor, but acquires an interest in the lessor's position by way of assignment. The assignment may occur either where the assignee purchases a lease, or where the assignment is made as security for a loan to the original lessor.

CAPITAL LEASE AND OPERATING LEASE

In the United States, the IRS and FASB have provided mandatory models. The Internal Revenue Service was the first group in the United States to codify leasing rules, and these still exist. In 1955, Revenue Ruling 55-540 provided initial but very weak "non-guidelines" for lease classifications as either operating or capital. The IRS followed up this initial attempt with an improved, but still weak definition of operating and capital leases in 1975 with Revenue Procedure 75-21. Since then, the IRS has given the lease definition and measurement process little additional attention. Because what it has produced is impractical and insufficient for satisfactory application, the IRS tends to rely upon the subsequent and much superior FASB 13 in its deliberations.

In 1975 the Financial Accounting Standards Board issued FASB 13, which became effective in 1977. This is a much tighter document, which provides definitions and measurements for operating and capital lease classifications.

Under GAAP (SFAS 13), a capital lease exists if any one of the following four criteria is met:

1. The lessee is to get property ownership at the end of the lease term. This criterion is still satisfied if ownership is transferred shortly after the end of the lease term.
2. A bargain purchase option exists in which the lessee can either buy the property at a minimal amount or renew the lease at very low rental payments relative to the "going rates."
3. The lease term is 75% or more of the life of the property.
4. The present value of minimum lease payments at the start of the lease equals or exceeds 90% of the fair market value of the property. Minimum lease payments do not include executory costs to be paid by the lessor, which are being reimbursed by the lessee. Examples of such costs are property taxes, insurance, and maintenance. Executory costs also include lessee payments to an unrelated third party to guarantee the residual value. When the lessor pays executory costs,

any lessor's profit on such costs is construed the same as the executory costs.

If the answer to any of these questions is affirmative, the lease is a capital lease. If all four are negative, the lease is an operating lease.

THE ADVANTAGES AND DISADVANTAGES OF LEASING

A broker who has a potential client seeking funds for acquisition of additional business equipment should be prepared to explain the benefits of leasing, rather than borrowing for a purchase.

Leasing has many advantages for the lessee, including:

- Immediate cash outlay is not required.
- Typically, a purchase option exists, allowing the lessee to obtain the property at a bargain price at the expiration of the lease.
- The lessor's expert service is made available.
- There are usually fewer financing restrictions (e.g., limitations on dividends) placed on the lessee by the lessor than are imposed when obtaining a loan to buy the asset.
- The obligation for future rental payment does not have to be reported on the balance sheet in the case of an operating lease.
- Leasing allows the lessee under a capital lease, in effect, to depreciate land, which is not allowed if land is purchased.
- In bankruptcy or reorganization, the maximum claim of lessors against the company is three years of lease payments. In the case of debt, creditors have a claim for the total amount of the unpaid financing.
- The lessee may avoid having the obsolescence risk of the property if the lessor, in determining the lease payments, fails to estimate accurately the obsolescence of the asset.

There are several drawbacks to leasing, including:

- There is a higher cost in the long run than if the asset is purchased.
- The interest cost associated with leasing is typically higher than the interest cost on debt.
- If the property reverts to the lessor at termination of the lease, the lessee must either sign a new lease or buy the property at higher current prices. Also, the salvage value of the property is realized by the lessor.
- The lessee may have to retain property no longer needed (i.e., obsolete equipment).
- The lessee cannot make improvements to the leased property without the lessor's permission.

SALE-LEASEBACK FINANCING

A sale-leaseback is a financial transaction which provides a borrower with immediate cash and the added benefits of tax-deductible payments.

Sale-leaseback is an alternative to conventional methods of financing. A client's need for funds can be satisfied regardless of amount or reason, at a net cost usually below what he himself can arrange. In most cases, he will save thousands of dollars with a sale-leaseback, compared to the same amount borrowed from his own bank, and in spite of the loan carrying a lower stated rate of interest.

Your clients can receive substantial tax savings each year by writing off their lease payments. These tax savings greatly reduce the net cost of borrowing. The tax savings from writing off lease payments are considerably greater than the tax savings from merely writing off the interest of a loan.

Traditionally someone seeking funds tries to satisfy their financial needs through borrowing from banks and finance companies. A borrower's relationship with his bank usually includes his checking account, business loan, car loan, home mortgage, etc. After several transactions are established the client begins to rely totally on the bank for all his money needs.

But in times of tight money, many people are finding it increasingly difficult to borrow from the local lending institutions. In addition there are instances when convenience and confidentiality are of prime consideration. Above all the business person seeks the lowest cost of money available.

A lender who writes sale-leaseback transactions will purchase the existing business equipment for a mutually agreeable amount, and thereby provide your applicant with the capital he requires. By selling his equipment, he raises more cash than may be available if he simply pledged the equipment to his bank as collateral for a loan. The lease value of the equipment may not be important to the lender!

The equipment is then leased back for three to seven years. The lessee makes payments just as he would if he borrowed the funds. But since the transaction is documented as a true lease his entire rental payments are tax-deductible as business expense.

Only sale-leaseback can offer a client both the benefits of cash in return for a static asset followed by tax-deductible payments.

BUSINESS FINANCING

SOURCES OF CAPITAL

Prior to approaching a lender or investor, you should be able to answer the following questions.

1. How much money do you need?
2. How do you plan to use the money you want to borrow?
3. How long will you need these funds?
4. How do you plan to generate sufficient cash flow to pay back the loan?

Sources of business capital include:

Personal Savings. The most common way of financing a business is with personal savings. Many times, personal funding is the only source of capital for a small business until an earnings record can be established.

Commercial Banks. Commercial banks make 85% of all loans to businesses. The bank loan is usually used for short-term (max.5 years), rather than long-term capital needs. Conservatism reigns - bankers are not in the business to help start up businesses. Their main loan criteria is that the loan be repaid.

Savings & Loans. Savings institutions are geared to lend money on real estate-based assets. Consider this type of institution if you have existing equity in real estate, whether personal or residential. Loan terms run up to 30 years.

Mortgage Companies. Mortgage companies are similar to savings institutions. The biggest difference is your loan is not held by the institution, but is sold to another investor. This means they may have more money to lend under a larger variety of different terms.

Venture Capitalists/Investors. Venture capitalists and individual investors typically will finance a significant portion of your capital needs, but in return they require a significant, usually controlling interest, in your company.

Thrift Associations. Thrift and loans, known as "hard money" lenders, are more apt to lend money than banks - at a significantly higher rate. Loans are typically made to the individual (owner) rather than the business.

Government Agencies. The Small Business Administration (SBA) lends to businesses who meet certain criteria. Minorities and women have more opportunities to receive these funds - but only if the business is sound.

Suppliers. Many suppliers are willing to extend credit to their customers if they are convinced that the business is a good risk and will grow appreciably over time.

Former Owners. If the business was purchased, the former owner may be willing to receive the sales price over an extended period of time.

Friends/Relatives. Many times friends and relatives are the source of business capital. This form of financing can be damaging to relationships if problems occur and may encourage outside interference from your investors.

SMALL BUSINESS ADMINISTRATION (SBA) LOANS

Established in 1953, the SBA helps small businesses with many programs that provide financial, technical and management assistance. Each year, the SBA helps more than one million small business owners. SBA offices in every state, the District of Columbia, the Virgin Islands and Puerto Rico deliver these programs. In addition, the SBA works with thousands of lending, educational and training institutions nationwide. For most small business advisors, the SBA loan programs will be the focus of their attention.

You should contact your local Small Business Administration (SBA) office to determine if you qualify as a small business. Size standards are subject to change. For example, a retail small business is defined as one in which annual sales or receipts do not exceed $3.5 million to $13.5 million, depending upon the size of the industry.

The SBA has a policy to make loans or guarantee loans to businesses that meet certain criteria. Minorities and women have more opportunity to receive these funds but only if the business is sound.

Direct assistance is subject to availability of funds. An applicant unable to obtain a loan or loan participation from a private lender may apply to SBA for a direct loan on a form provided by SBA. Such application shall be made to the SBA office serving the location of the proposed or existing business, but counseling may be obtained from any SBA office.

Before applying for SBA financial assistance, an applicant shall endeavor to obtain financing from other non-federal sources, including (but not limited to) other resources of its owners, and private lending sources. If an institution is unable or unwilling to make the loan, the applicant must then determine if the Lender would make the loan in participation with SBA as a guaranty or an immediate participation loan. (If a Lending Institute will make a loan in participation with SBA , the Lender, not the applicant, shall contact SBA.) SBA shall require satisfactory evidence concerning the Lending Institution's refusing to make or to participate in the loan.

Contents of Application. An applicant for SBA financial assistance in any form shall furnish a history of the business, the nature of the business, the amount and purpose of the loan, the collateral offered for the loan, and current financial statements, together with financial statements (or tax returns if appropriate) for the past three years. Annual financial statements shall be required from borrower thereafter, but SBA may also require more frequent reports. In addition, personal financial statements may be required, as applicable, from a proprietor, general partners, officers, directors, guarantors, and holders of twenty percent or more of the equity of the applicant. Financial statements from non-stock holder directors or officers may be waived by SBA.

Approval or decline. Applicants will be given notice of approval or decline by either the lender (for a participation/guaranty loan) or by SBA (for a direct loan). The decline notification will include the reason(s) for the decline.

SBA DECISION CONSIDERATIONS

Along with repayment ability from cash flow, good character, management capability, collateral, and owner's equity contribution are important considerations in SBA approval. Those who own 20% or more of the business are required to personally guarantee SBA loans.

Eligibility

Eligibility is generally determined by four factors:

1.Type Of Businesses Eligible

Most businesses are eligible but applicant businesses must operate for profit, do business in the U.S. or its possessions, have reasonable owner equity to invest, and they must use other financial resources first - including personal assets.

2.Size Of Businesses Eligible

An eligible small business is defined as one that is independently owned and operated and not dominant in its field of operation. The Small Business Act also states the definition of small business varies from industry to industry. SBA size standards define the maximum size of an eligible small business:

Retail and Service, $3.5 to $13.5 million

Construction, $7.0 to $17.0 million

Agriculture, $0.5 to $3.5 million

Wholesale, no more than 100 employees

Manufacturing, 500 to 1,500 employees

3. Use Of Loans:

Loan proceeds must be used for business purposes such as the purchase of real estate to house the business operations; construction, renovation or leasehold improvements; acquisition of furniture, fixtures, machinery, and equipment; purchase of inventory; and, working capital.

Proceeds can not be used to finance floor plan needs; to purchase real estate where the participant has issued a forward commitment to the builder/developer, or where the real estate will be held primarily for investment purposes; to make payments to owners or pay delinquent withholding taxes; to pay existing debt unless it can be shown that the refinancing will benefit the small business and that the need to refinance is not indicative of imprudent management.

4. Special Circumstances:

Franchises are eligible except when the franchisor has excessive control over the business.

Recreational facilities and clubs are eligible provided the facilities are open to the general public and membership is not restricted for any particular group.

Farms and agricultural businesses are eligible, but applicants should first explore Farmers Home Administration (FmHA) programs.

Fishing vessels are eligible, but those seeking funds for the construction or reconditioning of vessels with a cargo capacity of five tons or more must first request financing from the National Marine Fisheries Service.

Medical facilities, such as hospitals, clinics, emergency outpatient facilities, and medical and dental laboratories are eligible. Properly licensed convalescent and nursing homes are eligible if services exceed those of room and board.

Alter ego-while investment in real estate occupied by anyone other than the small business concern is not eligible, a holding company owned by the same parties and in the same proportion as the small business (alter ego) may be eligible if a number of conditions are met.

Change Of Ownership - Loans for this purpose are eligible provided the business benefits from the change. In most cases, this benefit should be seen in promoting the sound development of the business or, perhaps, in preserving its existence. Loans cannot be made when proceeds would enable a borrower to purchase: (a) part of a business in which it has no present interest or (b) part of an interest of a present and continuing owner. Loans to effect a change of ownership among members of the same family are discouraged.

Aliens - are eligible; however, status possessed, e.g., resident, lawful temporary resident, etc. is considered in determining the degree of risk relating to the continuity of the applicant's business.

Probation or Parole - applications will not be accepted from firms where one of those required to submit a personal history statement is currently incarcerated, on parole, or on probation, or a defendant in a criminal proceeding.

Ineligible Businesses:

Businesses engaged in illegal activities, loan packaging, speculation, multi sales distribution, gambling, investment or lending, or where the owner is on parole are not eligible along with the following specific types of businesses:

- Real Estate Investment and Other Speculative Activities
- Lending Activities
- Pyramid Sales Plans
- Illegal Activities
- Gambling Activities
- Charitable, Religious, or Certain Other Nonprofit Institutions

LOAN AMOUNTS, RATES AND FEES

Loan Amounts

Loan amounts vary by program. Since the maximum amount the SBA can guaranty is generally $750,000, a lender requesting the maximum SBA guaranty of 75 percent means that the total loan amount available would be limited to $1 million.

Interest Rates

Interest rates are negotiated between the borrower and the lender but are subject to SBA maximums, which are pegged to the Prime Rate.

Interest rates may be fixed or variable. Fixed rate loans must not exceed Prime Plus 2.25% if the maturity is less than 7 years, and Prime Plus 2.75% if the maturity is 7 years or more.

For loans of less than $25,000, the maximum interest rate must not exceed Prime Plus 4.25% and 4.75%, respectively; for loans between $25,000 and $ 50,000, maximum rates must not exceed 3.25% and 3.75%, respectively.

Variable rate loans may be pegged to either the lowest prime rate or the SBA optional peg rate. The optional peg rate is a weighted average of rates the federal government pays for loans with maturities similar to the average SBA loan. It is calculated quarterly and published in the "Federal Register."

The lender and the borrower negotiate the amount of the spread, which will be added to the base rate. An adjustment period is selected which will identify the frequency at which the note rate will change. It must be no more often than monthly and must be consistent, (e.g., monthly, quarterly, semiannually, annually or any other defined, consistent period).

Fees Associated With SBA Loans

The SBA charges lenders a guaranty and a servicing fee for each loan approved. These fees can be passed on to the borrower once the lender has paid them. Processing fees, origination fees, application fees, points, brokerage fees, bonus points, and other fees are prohibited. The only time a commitment fee may be charged is for a loan made under the Export Working Capital Loan Program.

Guaranty Percents

For those applicants that meet the SBA's credit and eligibility standards, the Agency can guaranty up to 80% of loans of $100,000 and less, and up to 75% of loans above $100,000 (generally up to a maximum guaranty amount of $750,000).

SBA LOAN GUARANTY PROGRAM

The 7(a) Loan Guaranty Program is one of SBA's primary lending programs and provides loans through private-sector lenders to small businesses unable to secure financing on reasonable terms through normal lending channels. The SBA guaranties the loans.

TYPES OF LOANS UNDER THE PROGRAM

SBA LowDoc

Designed to increase the availability of funds under $150,000 and streamline/expedite the loan review process.

SBA Express

Designed to increase the capital available to businesses seeking loans up to $150,000. CAPLines — An umbrella program to help small businesses meet their short-term and cyclical working capital needs with five separate programs.

International Trade— If the business is preparing to engage in or is already engaged in international trade, or is adversely affected by competition from imports, the International Trade Loan Program is designed for this purpose.

Export Working Capital— Designed to provide short-term working capital to exporters in a combined effort of the SBA and the Export-Import Bank.

Pollution Control— Designed to provide loan guaranties to eligible small business for the financing of the planning, design, or installation of a pollution control facility.

DELTA— Defense Loan and Technical Assistance is a joint SBA and DOD effort to provide financial and technical assistance to defense-dependent small firms adversely affected by cutbacks in defense.

Disabled Assistance — The SBA has not been provided funding for direct handicapped assistance loans, but such individuals are eligible for all SBA loan guaranty programs.

Qualified Employee Trusts— Designed to provide financial assistance to Employee Stock Ownership Plans

Veteran's Loans— The SBA has not been provided funds for direct loans to Veterans, although Veterans are eligible for special consideration under SBA's guaranty loan programs.

Energy & Conservation Loan— Provides financing for eligible small businesses engaged in engineering, manufacturing, distributing, marketing, and installing or servicing products or services designed to conserve the nation's energy resources. The maximum guaranty for loans up to $100,000 is 80 percent. For higher loans up to *$750,000,* the maximum guaranty is 75 percent.

Prequalification Pilot Loan Program-—— This program uses intermediaries to assist prospective borrowers in developing viable loan application packages and securing loans. Once the loan package is assembled, it is submitted to the SBA for expedited consideration; a decision is usually made within three days. If the application is approved, the SBA issues a letter of prequalification stating the SBA's intent to guaranty the loan. The intermediary, usually a Small Business Development Center, then helps the borrower locate a lender offering the most competitive rates.

Community Express—This is a pilot SBA loan program that was developed in collaboration with the National Community Reinvestment Coalition (NCRC) and its member organizations. Under the pilot, which will initially be limited to selected NCRC lenders, an SBAExpress like program will be offered to pre-designated geographic areas serving mostly New Markets small businesses. The program will also include technical and management assistance, which is designed to help increase the loan applicant's chances of success.

CAIP Loan Program——The United States Community Adjustment and Investment Program was created to help communities that suffered job losses due to changing trade patterns with Mexico and Canada following the North American Free Trade Agreement (NAFTA). The CAIP promotes economic implementation of the adjustment by increasing the availability and flow of credit and encourages business development and expansion in impacted areas. Through the CAIP, credit is available to businesses in eligible communities to create new, sustainable jobs or to preserve existing jobs.

OTHER SBA LOAN PROGRAMS

Microloan Program

This program works through intermediaries to provide small loans from as little as $100 up to $25,000.

Certified Development Company (504 Loan) Program

The 504 Certified Development Company (CDC) Program provides growing businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings. A Certified Development Company is a nonprofit corporation set up to contribute to the economic development of its community or region. CDCs work with the SBA and private-sector lenders to provide financing to small businesses.

Proceeds from 504 loans must be used for fixed asset projects such as: purchasing land and improvements, including existing buildings, grading, street improvements, utilities, parking lots and landscaping; construction of new facilities, or modernizing, renovating or converting existing facilities; or purchasing long-term machinery and equipment.

The 504 Program cannot be used for working capital or inventory, consolidating or repaying debt, or refinancing.

SURVEYS OF SELECTED SBA PROGRAMS

Small Business Investment Company Program

Licensed and regulated by the SBA, SBICs are privately owned and managed investment firms that make capital available to small businesses through investments or loans. They use their own funds plus funds obtained at favorable rates with SBA guaranties and/or by selling their preferred stock to the SBA. SBICs are for-profit firms whose incentive is to share in the success of a small business. In addition to equity capital and long-term loans, SBICs provide debt-equity investments and management assistance.

Angel Capital Electronic Network

ACE-Net (The Angel Capital Electronic Network) is a nationwide Internet-based listing service an Internet-based securities listing service that benefits entrepreneurs, accredited investors, accountants, and securities advisors. ACE-Net transforms the informal angel investment community into a nationwide system for entrepreneurs and investors to meet. ACE-Net, sponsored by the Office of Advocacy of the U.S. Small Business Administration, is a major effort to start systematizing, on a nationwide basis, and expanding information available to investors on firms seeking equity financing. The ACE-Net Internet site: **www.sba.gov/gils/SBA1998Mar05.101626.html**

8(a) Development Program

The 8(a) Development Program (8(a) Program) has been revamped into a business development program that provide entrepreneurs and contractors assistance in understanding, preparation, negotiation and assistance in competing for federal government contract awards. The 8(a) program is growing in its assistance to small businesses owned by socially and economically disadvantaged firms.

Small Disadvantaged Business Program

The SBA's minority development programs are intended to help small businesses be successful for the future. Companies just starting or in a growth stage can benefit from the wide-range services offered, including: support for government contractors, access to capital, management and technical assistance, and export assistance.

Women-Owned Business Procurement

This is a multifaceted outreach and educational program to teach women business owners to market to the federal government.

Prime Contracts Program

Prime Contracts Program works to increase the small business share of government contracts and advocates for the breakout of items purchased through full and open competition. SBA procurement center representatives (PCRs) review major federal procurement contract activities, review the subcontracting plans, recommend contracting sources and offer counsel. SBA's Office of Government Contracting Home Page is at **www.sba.gov/GC.**

Subcontracting Assistance Program

Promotes use of small businesses by major prime contractors. Commercial Marketing Representatives (CMRs) concentrate on large businesses that have contracts in excess of $500,000 and identify small business sources to satisfy specific needs of the prime contractor.

Certificate of Competency Program (COC)

COC helps small businesses secure Federal contacts by providing an appeal process to low-bidder firms denied government contracts for a perceived lack of ability or financial resources to perform the work.

Size Determination Program

Ensures that only small firms receive contracts and other benefits set-aside exclusively for small business. When a firm's claim that it is small is challenged, the SBA size specialists determine if the firm does, in fact, meet established SBA size standards. Size determinations may also be made when requested in connection with other federal contracting programs.

PRO-Net

PRO-Net is an electronic gateway of procurement information — for and about small businesses. PRO-Net is an Internet-based database of information on small, disadvantaged, 8(a) and women-owned businesses. It is free to federal and state government agencies as well as prime and other contractors seeking small business contractors, subcontractors and/or partnership opportunities.

PRO-Net is available at the Department of Defense's Central Contractor Registration (CCR). **www.ccr.gov/.**

SBIR

The Small Business Innovation Research Program helps to carry out the mission of the Office of Technology to strengthen and expand competitiveness of small business high technology research and development businesses in the Federal environment

The SBA's Disaster Assistance Loan Program

This loan program is the primary federally funded, disaster assistance loan program for funding long-range recovery for private sector, nonagricultural disaster victims.

Specialized Small Business Investment Companies (SBBICs)

These provide businesses owned by socially and economically disadvantaged individuals with equity capital, long-term loans, debt-equity investments and management assistance, particularly during business growth stages. SBBICs are a significant component of the SBIC program, accounting for more than a third of the program's financings. The SBBICs typically make smaller investments than SBICs.

Small Business Technology Transfer (STTR)

This program requires each small firm competing for an R&D project to collaborate with a nonprofit research institution. It is a joint venture from the initial proposal to the project's completion, and is administered by the SBA Office of Technology.

HUBZone Empowerment Contracting Program

The HUBZone Empowerment Contracting Program provides federal contracting opportunities for qualified small businesses located in distressed areas. Fostering the growth of these federal contractors as viable businesses, for the long term) helps to empower communities, create jobs, and attract private investment.

WHERE TO GO FOR ADVICE

U.S. Small Business Administration (SBA)

- SBA District Offices
- Small Business Development Centers (SBDCs)
- Service Corps of Retired Executives (SCORE)
- Small Business Institutes (SBIs)

www.sba.gov -- The SBA's site provides a gateway to a wide range of resources for information and services pertinent to small business.

Consult your telephone directory under U.S. Government for your local SBA office or call the Small Business Answer Desk at 1-800-368-5855, for information on any of the above resources. To access SBA OnLine (electronic bulletin board), dial 1-800/697-4636.

You may request a free Directory of Business Development Publications from your local SBA office or the Answer Desk. SBA has a library of over 100 business publications which sell for a nominal fee (most under $2). For a free copy of SBA's Directory of Business Development Publications write to Publications, P O. Box 15434, Fort Worth, Texas 76119 or contact your local SBA office.

Small Business Administration (SBA)
1441 L. Street
N.W. Washington DC, 20416
Toll-free telephone: (800) 368-5855
Free booklets are available.

Small Business Administration (SBA)
330 N. Brand Avenue
Glendale, CA 90203
Telephone: (213) 894-2956

Assistance Seminars. The SBA office in Los Angeles offers seminars with a broad range of subject matter. You may contact that office for information about time, place, and focus for each seminar.

Loans: For a complete understanding of SBA's loan policy and programs, the District Office should be contacted at (213) 894-2956.

Small Business Programs: Low cost seminars sponsored by your local Small Business Council offer business development advice and address topics of concern to small businesses.

Research & Publications: Your local Chamber of Commerce publishes a monthly Business Journal.

Women's Council: Provides a vital forum for individuals interested in furthering personal and professional growth. Provides business and civic-minded women with the support, encouragement and contacts they need for success; offering continuing support and advice. The council features workshops for management and a mentor series.

Small Business Institute: The Small Business Institute Program is a cooperative effort between collegiate schools of business administration, the small business community and the SBA. Under the supervision of expert faculty and SBA staff, qualified senior and graduate students of business work to provide on-site management counseling in business problems. Check with the nearest University's School of Business, Department of Management for more information.

SCORE (Service Corps of Retired Executives): Offering free counseling to any small business or any person planning a small business. Assistance with marketing, bookkeeping and business planning is available. Contact the local score counselor through the Chamber of Commerce.

Business Start-up Kits: Forms, simplified instructions, deadline calendar reminder labels...everything you'll need to comply with local, state, and federal government requirements through out the year. Employer's Kits are available at your nearest Chamber of Commerce.

VENTURE CAPITAL FINANCING

Venture capital firms supply funding from private sources for investing in select companies that have a high, rapid growth potential and a need for large amounts of capital. Venture capital (VC) firms speculate on certain high-risk businesses producing a very high rate of return in a very short time. The firms typically invest for periods of three to seven years and expect at least a 20 percent to 40 percent annual return on their investment.

When dealing with venture capital firms, keep in mind that they are under great pressure to identify and exploit fast growth opportunities before more conventional financing alternatives become available to the target companies. Venture capital firms have a reputation for negotiating tough financing terms and setting high demands on target companies. Three bottom-line suggestions:

- Make sure to read the fine print.
- Watch for delay maneuvers (they may be waiting for your financial position to weaken further).
- Guard your trade secrets and other proprietary information zealously.

Venture capital financing may not be available, nor a good choice of financing, for many businesses. Usually, venture capital firms favor existing businesses that have a minimal operating history of several years; financing of startups is limited to situations where the high risk is tempered by special circumstances, such as a company with extremely experienced management and a very marketable product or service. In 1995, venture capital firms invested in less than 2000 companies. The target companies often have revenues in excess of two million dollars and a preexisting capital investment of at least one million.

VCs research target companies and markets more vigorously than conventional lenders, although the ultimate investment decision is often influenced by the market speculations of the particular venture capitalists. Due to the amount of money that venture capital firms spend in examining and researching businesses before they invest, they will usually want to invest at least a quarter of a million dollars to justify their costs.

Be wary of "shopping" innovative ideas to multiple venture capitalists or private investors. Use caution in revealing any information you consider proprietary. Even if you already have intellectual property protection (e.g., a patent, trademark, or copyright), you don't want to be forced to police your rights. Do your best to limit the details of your particular innovation and seek confidentiality arrangements for additional protection of any preexisting legal rights you may have.

The price of financing through venture capital firms is high. Ownership demands for an equity interest in 30 percent to 50 percent of the company are not uncommon even for established businesses, and a startup or higher risk venture could easily require transfer of a greater interest. Although the investing company will not typically get involved in the ongoing management of the company, it will usually want at least one seat on the target company's board of directors and involvement, for better or worse, in the major decisions affecting the direction of the company.

The ownership interest of the VC firm is usually a straight equity interest or an ownership option in the target company through either a convertible debt (where the debt holder has the option to convert the loan instrument into stock of the borrower) or a debt with warrants to a straight equity investment (where the warrant holder has the right to buy shares of common stock at a fixed price within a specified time period). An arrangement that eventually calls for an initial public offering is also possible. Despite the high costs of financing through venture capital companies, they offer tremendous potential for obtaining a very large amount of equity financing and they usually provide qualified business advice in addition to capital.

Venture capital firms are located nationwide, and a directory is available for $25 through the National Association of Venture Capital, 1655 N. Fort Meyer Dr., Arlington, VA 22209, (703-351-5269). In addition, other sources for venture capital can be found through bankers, insurance companies, and business associations.

WORKING A LOAN ONLINE

For borrowing money, lenders look for security in your assets and cash flow in addition to your character, so if you can show a healthy balance sheet and a decent credit rating, you can borrow money easily on the Internet.

Among the most useful sites for business borrowers are:

- America's Business Funding' Directory, **(www.businessfinance.com**) operated by BFS Inc., of Irvine is a portal site to locate venture capitalists, commercial lenders, equipment leasers, investment funds, government funds, real estate financing and more. A panel of experts answer questions posted on the site's bulletin board. Some parts of the site are for members only
- Lendingtree (**www.lendingtree.com**) provide small business loans in the following types: line of credit, term or installment loans, and receivable financing.
- AmericaOneUnsecured.com (**www.americanunsecured.com**) offers an online application for all kinds of unsecured business loans.
- Lenders Interactive Services (**www.lendersinteractive.com**) is a Web-based loan broker for all types of financing: commercial real estate, equipment leasing, factoring, SBA, construction loans, rental property, franchises, and many more.
- BuyZone.com (**www.buyerzone.com**) helps get free business loans and leasing quotes from multiple lenders.
- **www.allbusiness.com**, Entrepreneur magazine (**www.entrepreneur.com),** Inuit (http:**//quicken.intuit.com),** and Inc. magazine (**www.inc.com/**) are also useful.

Many are Web-based loan brokers representing a number of banks nationwide--10 at last count--with more signing on monthly. You fill out an online application detailing your business operation and your need for the loan, along with some personal information. Once the Web site checks your personal and business credit ratings electronically, you can get an answer the same day for loans under $50,000. Loans for larger amounts require additional documentation, usually submitted by mail, so the approval process takes longer.

You can't apply online with America's Business Funding Directory. Instead, the site gathers your business and personal information, probes a database of hundreds of lending sources nationwide and lists those whose lending criteria appear to be a good fit for you. The Web page alerts the lenders of your query, prompting them to make contact with you. It also gives you the names and phone numbers of contacts at the lenders so that you can initiate the process yourself.

The site also offers useful pages detailing the ins and outs of commercial finance, equipment leasing, government funds, investment funds, real estate finance, venture capital, small business development councils and the Service Corps of Retired Executives, a nonprofit organization of business mentors and counselors **(www.score.org**).

The Business Finance Mart offers an online application for all kinds of loans, including factoring, sale-leaseback deals, loans guaranteed by the Small Business Administration, equipment leasing, lines of credit and start-up loans for entrepreneurs.

The Web site also has a bulletin board on which you can post items on buying or selling a business or buying or selling inventory or equipment.

In addition to these, lenders of every stripe maintain Web pages, including all of the big banks targeting business customers, plus commercial finance companies and other sources of business loans. Many allow you to submit online applications for business loans.

RAISING EQUITY AND VENTURE CAPITAL ONLINE

It is not possible to do an equity deal by remote control on the Internet. However, the Internet can help you simplify the first step in your search for equity or venture capital by getting your business plan in front of potential investors. A number of good Web sites seek to help you make these connections, among them:

- The Venture Capital Resource Library (**www.vfinance.com**), where you can post a synopsis of your business idea along with basic information about your business.
- The National Venture Capital Assn. (**www.nvca.org**), which lists over 300 venture capital and private equity firms along with links to many of their Web sites, allowing you to gauge the firms' likes and dislikes.
- **www.moneycafe.com/** allows you to identify specific banks, investment banks, venture capital firms, insurers and other sources of finance by state.
- Commercial Finance Online **(www.cfol.com**), where you can search through a large database for financing sources likely to have an interest in your business and its capital needs.
- The Angel Capital Electronic Network--ACE-Net for short (**http://activecapital.org/** -- A site partly sponsored by the U.S. Small Business Administration. It is an Internet securities listing service to help entrepreneurs and investors find each other. The site is hosted by the University of New Hampshire.
- Garage.com (**www.garage.com**), which matches entrepreneurs and investors through a rigorous and detailed "vetting" process probing business plans, management expertise, and the like.

Other Helpful Sites

- Do you know how to recover data if your computer crashes? Check out Ontrack's site at **www.ontrack.com**. The site includes services and software for data recovery and information about how to protect data and the cost of losing data.
- **www.planmaker.com** has links to many business plan templates and software makers.
- **www.officedepot.com** has free downloadable business forms in the following areas: Asset Protection, Business Finance, Compensation and Benefits, Employee Management, Firing and Termination, Government Contracting Forms, IRS Tax Forms, Marketing, Recruiting and Hiring, Starting Your Business, State Tax Forms, Worker Safety, Vehicles and Equipment.

- Microsoft Office Small Business Edition contains many useful templates and sample financial ratio analysis.
- www.thomasnet.com, owned by a subsidiary of Thomas Publishing Co. LLC, lists products and services from 650,000 companies in 67,000 categories. Separately, Thomas Publishing has an international directory with 700,000 manufacturers and distributors in 28 countries at www.ThomasGlobal.com.
- The Patent and Trademark Office has made the process of researching and applying for trademarks fairly simple through the Trademark Electronic Application System. The system is online at www.uspto.gov.
- PricewaterhouseCoopers conducted a report for the IFA Educational Foundation, which is broken down by state and congressional district. The information from that report, "The Economic Impact of Franchised Businesses" can be accessed online at www.franchise.org/content.asp?contentid=681.

C H A P T E R T H R E E

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REAL ESTATE LOANS

Learning Objectives:

After studying this chapter you will be able to:

1. Conduct a basic review of available real estate loans.
2. Define estates.
3. Prepare the transfer of deeds
4. List and give examples of the kinds of deeds.
5. List and give examples of real estate loan originations.
6. Arrange for residential loans.

Real estate loans are secured by a first, second or third mortgage on residential or commercial property. Because of the value of the real estate as collateral this type of financing is much more easily arranged with a lender than most other types of financing.

Amounts available are usually up to 80 percent of the appraised value, less existing mortgages. Loans for amounts that exceed this equity value can be arranged by using more than one property or using some other type collateral to make up the difference. Occasionally a lender may limit the loan to only a 70 percent or less equity position, but even rarer is the lender who will go beyond the 80 percent mark.

Rates will vary depending on collateral, credit and the current prime rate, and may range from 9 to 20 percent!

Terms can be fully amortized for up to 15 and 25 years for a second or third mortgage, and up to 30 or 40 years for a first mortgage with no balloon payments.

Interest-only payments are sometimes available on short-term loans of one to seven years. At the end of the one-to-seven year term there is a balloon payment of the principal balance due. The loans can usually be rewritten at that time if the borrower wishes.

Swing loans or "bridge loans" of a temporary nature are available while a property is for sale. The loan is paid off when the listed property is sold. These are usually limited to six months to one year.

New construction loan rates are tied to the prime rate and are floating. Monthly payments are interest-only until the project is complete (up to one year). Take-out financing (permanent mortgage) rates vary and are subject to availability.

BASIC REVIEW OF REAL ESTATE

Certain words and phrases in connection with real estate have a technical meaning and an interpretation other than that which may be attributed to them by average layman. The all-inclusive term "property" may be said to be the rights or the interest that a person has in lands and chattels to the exclusion of all others. Blackstone defines land as comprehending all things of permanent, substantial nature. Estate stands for quantity and title refers to quality. All property of whatever kind and description that is capable of being owned must fall into one of two classes: personal property or real property.

PERSONAL PROPERTY DEFINED

Personal Property is anything that is movable. If it can be readily picked up and moved, or if it can be moved without breaking it loose from a building or other structure, then it is personal property.

Property that is movable can become permanently attached to land or buildings and thereby become real property. For example, a tree growing on the ground is real property. When it is cut down, it becomes personal property. After it is sawed into lumber it is still personal property; however, when the boards are nailed to a building they are real property.

REAL PROPERTY DEFINED

Real property is land, buildings, or things attached thereto. The essential point to remember is that real property is immovable.

There are three kinds of real property:

1. Land or earth in its natural state is always real property.
2. Buildings are real property. Houses or buildings that are attached to the land are also called appurtenances. Trees, shrubs, fences, and buildings are appurtenances because they are attached to the land. They may also be called tenements. Tenements are anything attached to the soil.
3. Fixtures: included here for convenience's sake, since they are somewhat of a hybrid between real and personal property. They may be treated differently in some cases. A fixture is property which was originally personal property and then became attached

either to the land or to a building. A test of whether an object is a fixture, is the intent of the person who put it there. If his intent was to leave it with the building, then it is real property. If not, then it remains personal property. This intent can be determined by the facts in each case. In general, if the item was permanently affixed to the building - nailed, screwed, or permanently bolted down - it is real property. If not, then it remains movable and therefore, is personal property. Further, if damage would result from the removal of the item from the building, it would show that the person who put it there intended to have it remain, and it is therefore real property.

ESTATES

The word *estate* refers to and means the degree or extent of ownership in property. It does not refer solely to things left at death, but also to the interest of a living person.

There are various ways a person can hold an interest in real property. First we will discuss the means by which one person holds only real property. When property is owned by one person only, this is called severalty ownership.

FEE SIMPLE ESTATE

Fee Simple Estate (also called Sole Tenancy) is the greatest and highest degree of ownership in real property. The most important characteristic of a fee simple estate is that is has indefinite duration. Since it has indefinite duration, the owner can pass it down to his heirs when he dies.

LIFE ESTATES

The word estate means ownership; therefore a life estate means ownership of real property for the lifetime of the grantee. *e.g.* If a man wants his mother to have a home for the rest of her life, he could buy a house and lot, convey to his mother a life estate for her life and keep the remainder for himself. Her rights to the property last as long as she lives. When she dies her son has a fee simple estate revert to him automatically.

Statutes in certain states create certain types of life estates. These laws set forth the estate that a husband or wife gets when the spouse dies. In states where it applies, dower is the right of the wife to an undivided one-half interest in her deceased husband's real property for her life. Curtsey is the right of the husband to an undivided one-half interest in his deceased wife's real property for his life.

There are three types of estate where the ownership of real property is held by two or more persons at the same time. They are:

1. Tenancy by Entirety.
2. Tenancy in Common.
3. Joint Tenancy.

TENANCY BY ENTIRETY
Tenancy by Entirety is an estate held by husband and wife only with the right of survivorship. Each spouse holds an undivided one-half interest in the property with the right of survivorship.

TENANCY IN COMMON
A tenancy in common is an estate held by two or more persons without the right of survivorship, the other co-tenants do not receive one owner's undivided interest upon his death. The deceased owner's will must provide inheritance rights.

JOINT TENANCY
A joint tenancy is an estate held by two or more persons with Right of Survivorship. This estate may be held by two, three, or any number of persons. Each joint tenancy holder owns <u>all</u> the property in question. This is the most popular form of tenancy in most states, but is not legal in all states.

DEEDS

A deed is an instrument that conveys title from the grantor (owner of title) to the grantee (recipient of title). It is a voluntary conveyance when made under an order of the court. The following statements on deeds apply generally, but some state laws may vary and should be checked.

REQUIREMENTS

1. A deed, to be effective, must be signed and delivered. Title to the real property passes from the grantor to the grantee when the deed is handed to the grantee. The signing and delivery of a deed is called the act of execution.
2. To be legally effective, a deed need not have a date in most states. Good procedures, however, suggest it should be dated.
3. To be legally effective, a deed does not always have to be recorded. Again, a sound procedure will be to file the deed.
4. In most jurisdictions, to be recorded, a deed must be acknowledged. The acknowledgement of a deed or other instrument is the notary paragraph at the bottom of the instrument. Acknowledgement is admitting before a Notary Public that you voluntarily executed the document.

KINDS OF DEEDS

GENERAL WARRANTY DEED

In addition to conveying title to real property, a general warranty deed contains certain warranties as to the title. A warranty is a promise made by the grantor as to the condition of title. If it is not true, the grantee may look to the grantor by a suit for breach of warranty.

The warranties are:

A. That the grantor is the owner of the property.
B. That he had good title.
C. That he has the right to convey.
D. That the property is free from encumbrance other than as expressed in the deed.
E. That the grantor will defend this title against the whole world.

SPECIAL WARRANTY DEED

In addition to conveying title to real property, a special warranty deed warrants *A* through *D* above but only as to the acts of the grantor or those who acted through him.

BARGAIN AND SALES DEED

Conveys title to real property without any warranties whatsoever. It is frequently used by the county or state to convey title to an individual, since the county and state do not wish to warrant title. The fact that a Bargain and Sale deed is used does not mean a title company will not issue title insurance. It will if their records show the title is good. The only difference is that the grantor cannot be sued for breach of warranty, since he made none.

QUIT CLAIM DEED

A release of all right, title, and interest of a grantor in real property; used especially where there may be a question or a cloud on the title. This type of deed surrenders any right to a future claim.

DEED OF TRUST

A deed of trust has not been defined, because, despite the name, it is *not* a deed.
A final point on deeds: check your state law for any variations or additions to the above general description.

REAL ESTATE LOAN ORIGINATION

Loan origination is a key element in any lending process. It demands the skill to develop the contacts that lead to loan requests, and the ability to process these requests so that the lender places a good loan on its books.

The real estate business is competitive; not only are many banks active in real estate lending, but so are other financial intermediaries. The active broker will develop all potential sources of good real estate loans - for example, by participating in community activities.

Good loan origination activity is the first defense against poor closing ratios. A skilled origination procedure will reduce the risk of working "undoable" loans and with the proper paperwork approach to satisfy any FHA, VA, or private insurance company requirements. It also can insure that title and other lending requirements have been observed.

Loan origination techniques, therefore, are most important to development of good real estate loans.

CREDIT GUIDELINES

Underwriting a loan application is an objective analysis of evaluating the degree of risk inherent in a loan. Two major questions you should ask yourself are:

1. What is the borrower's ability and willingness to pay, and
2. Is the property an acceptable security for the proposed debt?

Underwriting is a judgmental process utilizing common sense, an inquisitive or questioning mind, knowledge of credit analysis through experience and education and attention to detail.

A professional loan broker probably has most of these prerequisites, and by applying himself/herself can make a reasonably accurate judgment of the buyer's acceptability as a borrower before proceeding with a full packaging procedure.

INCOME AND EMPLOYMENT

The FHA, VA and most lending institutions require written verification of the loan applicant's employment for at least the past twenty-four (24) months. This verification process is also used to verify current income. The past and present employment and income picture is usually the best indication of an applicant's future job stability an probability of steady or increasing income. When discussing this subject with your borrower, it may be helpful to distinguish between "quantity" and "quality" of income.

Frequent job changes resulting in little or no advancement in the same line of work, or a shift to a new field of employment within the last two years should be carefully looked at with regard to other items.

Recent school graduates. Borrowers who have recently entered the job market and, especially those who have been in school or military service just prior to regular employment, normally receive favorable consideration when lenders estimate future income potential.

Self-employed individuals or applicants on commission must demonstrate, by past income records, their potential for stable, continuous income. Income that is not declared for tax purposes, or that is offset by business expenses is normally not considered by lenders. (Use the applicant's "taxable income.") A conservative method used by some savings and loans for considering commission or self-employed income is to average the last two (2) years' taxable income, assuming the applicant's income has increased or remained stable.

Secondary income such as bonuses, overtime, or part-time employment can be recognized as "stable monthly income" if such items of secondary income are typical for the occupation, substantiated by the applicant's previous year's earnings and/or by the employer, and continuation is probable based on foreseeable economic circumstances. Lenders are wary, however, of the old ploy of a prospect getting a part-time job to qualify for the loan, then quitting it after settlement. A good job history is important here.

Alimony and child support income must be considered by a lender if the applicant wishes to disclose it. However, it must be documented - usually by copies of the canceled checks from the payor for the past 6-9 months and a copy of the written agreement or court decree. If the canceled checks are not obtainable, contact the lender to determine if alternative documentation is acceptable. Also, if child support will cease shortly due to the age of the child(ren) involved, that income may not be considered.

Age of Applicant. In order for a buyer to obtain financing for his or her purchase, he or she must have reached (or will reach prior to settlement) the legal age (18 in most states) at which the mortgage note is personally enforceable. If an applicant is about to retire, the loan is underwritten on the basis of retirement income and the financial reserves available for living expenses and monthly payments. Discrimination solely on the basis of age is prohibited by the Equal Credit Opportunity Act (ECOA).

ASSETS

The assets of the applicant are examined from two points of view - has the applicant demonstrated an ability to accumulate cash and other forms of assets (which is a positive influence on a marginal case), and does he or she have enough liquid assets to meet the settlement requirements (down payment and closing costs)? Examples of "liquid assets" include: cash in bank or on deposit with builder/broker; easily-marketable stocks and bonds, including U.S. Savings Bonds; proceeds of sale of real estate, and/or a bonafide gift which does not have to be repaid.

FHA and conventional lenders both permit borrowing funds for closing on a secured basis, *i.e.,* by means of a loan using a tangible asset as collateral - such as a vacation home or lot, an automobile, or stocks and bonds. They do not permit borrowing on an unsecured basis to raise money for closing. Property to be financed by FHA, or with a conventional loan exceeding

80% of value, may not have a second mortgage placed on it to complete the purchase. (The latter is a limitation imposed upon federally-insured financial institutions and by FNMA, FHLMA and GNMA.)

VA loans. The VA permits secured or unsecured borrowing for closing costs and prepaids, if the veteran can support the additional debt. Borrowing the difference between the VA appraised value and the purchase price (if the purchase price is greater) is *not* permitted. Note: As opposed to conventional loans, FHA/VA loans normally have lower down payment, assumability, lower interest rate, and no prepayment.

Another home to sell. Funds advanced under an Employer's Home Sale Guarantee Plan are acceptable to most lenders. The terms of the plan must be fully documented. If the applicant has another home to sell, unless he or she can support all debt payments, "bridge" loans are normally not acceptable to FHA or VA and evidence of settlement on the prior home is usually required at or prior to closing on this transaction. Conventional lenders, especially on low down payment loans, can be expected to take the same position.

LIABILITIES

Every lender, as well as the FHA and the VA consider the long-term debts of an applicant in qualifying him or her for a mortgage loan. A liability is any debt or obligation to which a person is legally bound, or otherwise obligated to make good or repay. This includes obligations to pay alimony, child support or separate maintenance. In qualifying borrowers, include all debts with remaining terms of more than:

Lender/Agency	Number of Months
FHA	11
VA	5
FHLMC	10
FNMA	10

Credit Union debts are obligations just like other forms of installment debts and must be disclosed by the borrower.

Short-term debts are normally not counted against the borrower in computing total debt payments. You should, however, encourage the borrowers to disclose all debts, no matter how small. Lenders and FHA/VA will consider a short-term debt with a large monthly payment and/or an accumulation of small debts if it appears the amount of the monthly obligations will have a severe impact on the applicant's ability to pay all debts during the initial, critical months of the mortgage loan, or if there is an indication that the applicant continually obligates himself/herself for additional debts up to or over his/her ability to carry them.

Credit reports, or direct written verification of all debts are required by FHA, VA and conventional lenders. Adverse credit ratings with present and/or former creditors and landlords can prevent your prospect from purchasing the home of his or her choice. If you have any reason to suspect credit problems, ask your prospect if he/she has had any credit difficulties. When the credit standing is in doubt, most mortgage bankers are willing to take "pre-contract information" from your prospect to obtain a report on his/her credit and employment, and to advise you if mortgage financing looks feasible.

Federal laws and regulations have made it very difficult for the mortgage lender to advise the applicant and especially the real estate sales agent whenever something of an adverse nature appears during the verification process. Thus, the applicant is told the general problem and is requested to make direct contact with the credit bureau or source of the independent verification; or, the agent is advised of the general problem and told to consult with his/her buyer when the lender is in receipt of adverse information which may require an explanation. This often creates the impression of an "impersonal" institution, which is not really true. However, to comply with the letter and spirit of the laws concerning privacy and confidentiality of information, lenders must adopt this posture.

Job Related Expenses. The Veteran's Administration in particular, and some conventional lenders, may include the costs of child care, union dues, significant commuting costs, *etc.*, in calculating an applicant's debt obligations. Conversely, in light of today's high gasoline costs, if the buyer's place of business is easily accessible from his/her proposed home by public transportation, and the buyer intends to use such transportation, be certain to indicate this to the lender when presenting a marginal application.

Bankruptcies and Judgments. Recurring judgments by creditors or a recent petition for bankruptcy by the prospective buyer usually indicate an unsatisfactory credit risk to most lenders. However, the applicant who has had one or more judgments which were fully paid and satisfied over one year ago, or had a single bankruptcy action 10 years ago may be eligible for new mortgage financing. Lenders usually require a satisfactory explanation of the financial problems, evidence that the bankruptcy and/or judgments have been discharged or satisfied about a year before loan application with no new adverse information reported, and that a satisfactory credit standing has been re-established.

If your buyer recently had severe credit problems, contact your lender before writing a sales contract.

Wage Earner's Petition - Chapter 13 of Bankruptcy Act. A wage earner's petition under Chapter 13 of the Bankruptcy Act filed by the applicant is indicative of an effort to pay his/her creditors. Some plans may provide for full payment of debts while others arrange for payment of scaled-down amounts. Regular payments are made to a court-appointed trustee over 2 to 3 years. When the applicant has made all payments in a satisfactory manner, he/she may be considered as having re-established satisfactory credit. When he/she applies for a home loan before completion of the payout period, favorable consideration may nevertheless be given if at least three-fourths of the payments have been satisfactorily made and the Trustee and Bankruptcy Judge (Referee) approve of the new credit.

RESIDENTIAL LOAN TYPES

Unfortunately, no uniform origination nor underwriting guidelines exist for all residential mortgage loans. Brokers have had to adopt and follow different underwriting rules, regulations and formulas depending on whether a residential mortgage loan was conventional, FHA-insured or VA-guaranteed. It is important to realize only guidelines exist, not specific, precise formulas that can be applied to every applicant. Loan origination and the qualifying of a prospective borrower is an art, not a science, and the successful broker is one who can analyze all relevant material and match up the borrower with the proper lending institution.

CONVENTIONAL LOANS

A conventional real estate loan is any loan secured by real estate that is made at the risk of the lender without benefit of government insurance or guarantee. The term conventional includes those loans insured by private insuring agencies, where loan-to-value ratios exceed the limitations set by banking laws or policies for uninsured mortgages set by a particular bank or the secondary market.

The conventional mortgage has been the traditional method of financing real estate purchases in this country.

The past decade has seen may significant changes in the conventional mortgage market which have directly affected your ability to arrange financing for your borrower. The major impact on local lending has come from the tremendous growth of the conventional secondary mortgage market and the resulting widespread standardization of underwriting policies and loan documentation by local lenders. For example:

a. It is now easier for you to determine if your borrower qualifies for a conventional loan as more conventional lenders adopt the FNMA/FHLMC methods of underwriting.
b. The terms and conditions of the deed of trust (mortgage) and deed of trust note are usually those established by the secondary market leaders, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, (who have published standard forms for use in each state), and
c. The ability of local lenders to sell their conventional mortgages in the secondary market enables them to replenish their money supply available for new loan applications.

Also heavily impacting on all lending practices has been the enactment of several laws regulating home mortgage lenders. The Equal Credit Opportunity Act (ECON) prohibits lenders from discriminating in extending credit, with the direct result that, for example, persons divorced, separated or of minority groups find it much easier to obtain desired financing today than a decade ago.

Despite this trend toward uniformity, you must remember that the conventional loan is still essentially a private contract, or agreement, between two parties. Each conventional lender is still able, within legal limits, to set his own underwriting policies. Thus, the seasoned broker follows the maxim, "KNOW YOUR LENDER."

ELIGIBLE PROPERTY

Lenders normally offer their best terms for *single-family detached* owner-occupied dwellings less than ten years old.

"Owner-occupied" means that the borrower uses the property as his/her primary residence.

Townhouses are often treated equally as detached homes - but some lenders do differentiate.

PUDs (planned unit developments) and *condominiums* may be excluded from a lender's list of acceptable properties, since they may require a higher interest rate. Many lenders who are willing to make condominium loans will do so only if the condominium project has been approved by FNMA (FNMA publishes a list of approved condominiums and PUDs) or eligible for sale to FHLMC (FHLMC does not approve condominiums and PUDs - they set minimum standards which must be certified to by the local (direct) lender.)

2-4 Family Dwellings may be sold to FNMA and FHLMC. (FHLMC limits loans on 2-unit dwellings to 90% of value and 3 and 4 apartment dwellings to 80% of value.) Again, however, the local lenders may not wish to make these types of loans or may require higher rates. They also tend to be very conservative in counting rental income to qualify the borrower.

Vacation or Secondary Homes are not eligible for sale to FNMA or FHLMC. The few conventional lenders who are willing to accept loan applications on these properties typically require higher interest rates and/or the payment of several discount points. The broker must be prepared to sell these facts to their prospective borrowers.

FNMA will consider purchasing 2-4 family properties bought for *investment.* (The buyer does not intend to occupy one of the units.) However, the maximum mortgage permitted cannot exceed 80% of value.

Older homes are usually acceptable as security for conventional financing, unless:

1. The property is in fair-to-poor condition and/or requires major repairs, or
2. The remaining economic life of the property is insufficient to support the term of the loan.

If you have any questions about the acceptability of the property, call the lender.

TERM
The maximum loan term available is thirty (30) years. This may be reduced by a lender if:

a. They have a shorter maximum term as company policy.
b. The remaining economic life of the loan does not support a 30-year mortgage. (Typically, the maximum term is three-fourths of the remaining economic life.)
c. The age of the borrower indicates that a shorter term is appropriate. (*Note*: While a lender may not be discriminated on the basis of age, they may reduce the loan term on the basis of statistical life expectancy of the borrower. As a practical matter, it is now common for lenders to routinely grant 30-year loans to elderly borrowers.)

INTEREST RATE AND DISCOUNT POINTS
There currently exists a Federal Law pre-empting state usury ceilings. As long as this law is in effect and not superseded by new state legislation, lenders are permitted to charge rates, discount points and fees on first mortgage (deed of trust) loans without limitations.

CONVENTIONAL LOAN INCOME RATIO
For conventional lending purposes, when we speak of an income ratio of 25 percent it means simply, "A person should not spend more than 1/4 or 25 percent of his gross income on housings."

EXAMPLE

An applicant wishes to purchase a home and requests a loan of $20,000 for 25 years. The mortgage rate is 8 percent and the taxes are $600.00 per year. The fire (homeowners) insurance is $48.00 per year.

Monthly Principal & Interest	$154.37
Property Taxes ($600¸ 12)	50.00
Fire Insurance ($ 48¸ 12)	4.00
Monthly payment	$208.37

$208.37 X 4 = $ 833.48 Monthly income requirement
$833.48 X 12 = $10,001.76 Annual income requirement

To simplify the calculation you can use a factor. You may multiply the monthly loan payment by the factors below to arrive at the annual income requirement.

20 percent ratio factor is 60
25 percent income ratio factor is 48
30 percent income ratio factor is 40

With the factor, you would multiply $208.37 by 48 and arrive at the same figure of $10,001.76.

VETERANS ADMINISTRATION LOANS
A Veterans Administration real estate loan is any loan secured by real estate made to an eligible veteran in which a portion of the loan is guaranteed by the Veterans Administration. The veteran, the property, and the loan must meet the requirements of VA.

FEDERAL HOUSING ADMINISTRATION LOANS
An FHA real estate loan is any loan secured by real estate in which the lender is insured by the Federal Housing Administration. The borrower, the property, and the loan must comply with requirements that have been established by FHA. These requirements can be determined, for the many differing types of FHA programs, by publications of the Department of Housing and Urban Development (HUD). The HUD-FHA was originally established to: (1) upgrade housing standards, (2) promote wider home ownership, and (3) provide continuing and sound methods of financing home mortgages.

Income evaluation by FHA credit underwriters varies by areas. "Generally speaking, if the total prospective housing expense does not exceed 35 percent of net effective income, and the combined total of prospective housing expense and other recurring charges does not exceed 50 percent of the net effective income, this relationship would be considered adequate unless the family has already demonstrated an inability to manage its affairs adequately in a situation in which housing expense and/or total obligations were at or below these percentages. Income may also be considered adequate in cases in which the prospective housing expense exceeds 35 percent of net effective income where there are favorable, compensating factors that tend to reduce the risk in marginal cases," according to one FHA document.

This is a rule of thumb, spoken of as the 35-50 rule. Based on this rule, the form which follows (FHA Income Qualifying Statement) was designed to be used by loan originators and processors:

LOAN BROKER'S 35 - 50 RULE

FHA INCOME QUALIFYING STATEMENT

GROSS FAMILY INCOME:	_____	
Less Federal Withholding	_____	
NET EFFECTIVE INCOME:	_____	
Proposed payment	_____	
Maintenance	_____	
Utilities	_____	
TOTAL HOUSING EXPENSE:		_____
Divide net effective income into housing expense (Should not exceed 35%^)	_____	
Housing Expense	_____	
Installment Account Payments	_____	
Life Insurance	_____	
State Withholding	_____	
Social Security	_____	
TOTAL FIXED PAYMENT:		_____
Divide net effective income into total fixed payment (Should not exceed 50%)		_____

NET EFFECTIVE INCOME:	_____
LESS TOTAL FIXED PAYMENTS:	_____
NET REMAINING INCOME	_____

FICO SCORES

A FICO (an acronym for Fair, Isaac & Company), or credit score is a computer-generated numerical grade that predicts a lender’s risk in doing business with a borrower. Any company or individual that issues mortgage loans, home-equity loans, car loans, insurance policies, or healthcare services (even the IRS) bases much of its lending decisions and terms on the applicant's FICO score. FlCO scores are determined by computers and released through the three credit bureaus to their subscribing members. At Experian, the scores are called *Experian/Fair, Isaac*; at Equifax, they are called *Beacon* scores; at Trans Union, they are called *Empirica* scores.

Scoring is based on things like time on the job, the time you've lived at your current address, plus about 30 other factors, none of which are your income or assets:

1. *Payment history.* Do you make your payments on time? Have you had accounts turned over to collection? FICO deducts points for bad behavior, and it gives points for maintaining a good payment relationship.
2. *Outstanding debt.* FICO is very interested in the number of balances you have currently; the average of all balances, and the relationship between the total balance and total credit limit. Carrying too much credit lowers your score even if some of your accounts have zero balances, but FICO doesn't like to see you close to or at your limits, either.
3. *Credit history.* FICO looks at how long you've had those accounts, the total number of inquiries, and if you have opened new accounts. It is highly concerned about inquiries and accounts less than 12 months old.
4. *The types of credit you use.* FICO is very interested in the diversity of the credit you use. It looks to see if you use department store or bankcards, debit or credit cards, travel and entertainment cards, personal finance companies, and installment loans.
5. *Negative information.* Bankruptcies, late payments, collections, late fees, too many credit lines with maximum available funds borrowed, too little credit history (less than five credit lines in the past two years), and too many credit report inquiries are considered negatives.

What is considered a good score varies from lender to lender. FICO scores range from 375 to 900 points, and a score of 650 to 675 is generally considered excellent. However, to qualify for the most favorable terms, a lender might require a score in excess of 700.

C H A P T E R   F O U R

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INTRODUCTION TO COMMERCIAL REAL ESTATE FINANCING

Learning Objectives:

After studying this chapter you will be able to:

1. Analyze income property loans.
2. Depict the income-property lending process.
3. Arrange for interim loan underwriting.
4. Locate permanent mortgage investors.
5. Establish the process for financing apartments.
6. Outline apartment loan underwriting guidelines.
7. Arrange for shopping center financing.
8. Utilize the financing opportunities available for office-warehouses.
9. Facilitate financing for general offices (multi-tenancy).
10. Locate and arrange financing for medical office buildings.
11. Select financial package for mobile home parks.
12. Plan and evaluate financial packages for hotels and motels
13. Summarize the financial organization need for nursing homes.
14. Arrange for construction loans.

The classification of real estate known as income property (or commercial) can be defined as that real estate conceived, built and operated for the purpose of producing income. This income is realized either as actual cash or on the income-property owner's balance sheet as a tax shelter, or this income can be realized as actual (*e.g.* if the owner occupies the property).

Property of this type is purchased or developed as a long range income production investment. So long as the property continues to produce a steady flow of reasonably assured income in an adequate amount, it has marketability. If it has marketability, it can be financed. For underwriting loans of this type (except for apartments and general offices), the lender's primary underwriting considerations, in their order of importance, are:

1. Credit
2. Credit
3. Credit -- and more credit
4. Location

5. Type of real estate and its similarity to other buildings of its type in the area.

The repeated emphasis on credit is a way of saying that even if the real estate is only a tarpaper shack located in a swamp, if it is leased to General Electric or A T & T it is a desirable real estate project.

The only time a commercial real estate loan must be foreclosed is when the property ceases to produce income or produces insufficient income to make ownership a profitable venture. There is probably no greater white elephant than an income property which produces no income or produces income in an amount which does not justify its "brick and mortar" value. Obviously then, if the project is poorly underwritten from the standpoint of the property's income producing capability, the owner and the lender must be prepared to take a substantial loss at a foreclosure sale.

The market value of all commercial or industrial property, including apartments, is directly and precisely related to the *amount* of income it will produce, the *reliability* or quality of the income stream, and the *duration* of the income stream. For these reasons, there is a wide variance in interest rates, loan-to-value ratios and terms of mortgage financing available for commercial properties. The relationship between the three factors is:

1. *Amount of income* furnishes the *basis for value*.
2. *Quality of income* furnishes the basis for *loan-to-value ratio.*
3. *Duration of income* furnishes the basis for *loan term.*

The real estate is important only in an indirect way, i.e. if a tenant considers the real estate desirable for his purposes, he will pay a reasonable rent for its use. A lender may be willing to extend the term of his mortgage beyond the lease term. But this is matter of conjecture, hence its weight for underwriting purposes is of limited significance. Where income producing properties are concerned, the lender concentrates on the "sure thing" aspects of the proposal, which is the existing certain lease term.

While the above explanations are basic only in nature, they should establish a basis for differentiating between a "real estate loan" and a "credit loan."

There are two investors attitudes which bear on income property loans, whether credit or real estate type. The first involves the "principal" of conformity" which holds that maximum value is achieved when there is substantial "conformity in use." For example, most investors prefer apartments located in an apartment neighborhood rather than a lone building even though the building might be situated in a good residential area with little competition nearby. In other words, conforming use is preferred to limited competition. The other investor attitude is a general reluctance to finance income producing properties whose income flow hinges on a high degree of management skill.

This income property classification can be stated another way: *General use* and *special use* property. A general use property could be a retail space in a shopping center since that space could be used by many different types of retail outlets. Churches, factories, bowling alleys and grain elevators are examples of special use properties because their special architectural requirements are useable only for a specific purpose.

Since lenders take a greater risk with a special use property, they insist on greater protection through such items as a higher interest rate, personal or corporate guarantees or pre-leasing requirements.

General use properties include:	**Special** use properties Include:
Apartment Buildings	Hotels and Motels
Office Buildings	Mobile Home Parks
Retail Outlets	Churches
Shopping Centers	Banks
Industrial (multi-purpose)	Nursing Homes and Hospitals
Some Warehouses	Theaters
	Restaurants

ANALYZING THE INCOME PROPERTY LOAN

The analysis of this type of loan must be extensive to protect and provide information for all parties involved. A borrower must be satisfied that the property to be bought or built will provide a reasonable return on the investment. This of course will vary according to each borrower's unique financial position after consideration of taxes, leverage, cash flow, and depreciation. No single income property arrangement will satisfy all needs or all borrowers.

Of particular importance to all parties is whether this arrangement creates more value than it will cost to produce. Of course, a borrower may intend to get only tax benefits from a particular transaction.

Every income property loan should be analyzed according to:

- Feasibility
- Location

- Timing
- Borrower
- Real Estate

FEASIBILITY
Although a permanent investor will regard location as the paramount issue because of concern for the safety of its investment, both the borrower and the mortgage intermediary are initially concerned with the concept. Questions must be answered, such as: "Will this project work at any cost? Does a need exist that this project can satisfy on a practical basis?" If the answer is yes then it must be determined if the transaction can create value and give the borrower the requested loan while protecting the interest of the permanent investor.

LOCATION
As the location for the proposed construction is analyzed, particular emphasis should be placed on competing properties, population growth, income level, stability of employment, accessibility by automobile and public transportation, and any other factor which will affect the project at this location. This is often called a market analysis. Although a few deals will work almost anywhere, good location usually is required.

TIMING
Assuming that the concept is financially sound, the figures work and a good location exists, the timing of the project is of crucial importance. If three months before the project is completed a similar one is opened elsewhere, in all probability this so-called good deal will fail, or at best have trouble renting. A rent cut may be necessary to attract tenants.

BORROWER
An entrepreneur is the most important link in the whole income-property financing chain. Without an entrepreneur's skill and a desire to create value where none existed or to increase existing value, the entire field of income property financing would be entirely different.

It is imperative that this entrepreneur have a successful track record. This record should be indicative of the entrepreneur's ability as a manager, because many developers want to manage the completed project to save management fees which normally are 5 percent of gross income.

The permanent mortgage investor is interested only in the borrower's ability to build the project according to plans and specifications and, most importantly, within budget. After the project is completed and funding by the permanent mortgagee has occurred, the borrower takes on secondary importance behind the tenants and the real estate.

Some lenders will attempt to get personal endorsements which obligate a borrower to repay the mortgage debt if a default occurs. Although these have questionable value in some jurisdictions, the entire financial condition of the borrower must be open to examination. An audited financial statement of the borrower's personal and professional status must be obtained.

REAL ESTATE

For many years the value of the real estate served as the matrix for establishing the mortgage loan. It was assumed that a lender should be able to appraise the value of the real estate against which it was lending and by lending 75 percent of value have sufficient protection against any possible loss through the 25 percent equity if problems developed. Normally this is a valid assumption, but lenders have learned that most of the value created has a direct correlation to the general economic climate. A change in the economy could affect spending, which in turn could affect the mortgaged premises. Because of these problems, many lenders started to consider not only the real estate as security, but also the credit of both the borrower and long-term tenants.

THE INCOME-PROPERTY LENDING PROCESS

The stages through which an income property loan progresses are not always in the same order. But for the purpose of this text, the stages will be organized in a typical sequence.

The origination of this type of loan by a broker is generally quite different from the origination of a typical residential mortgage loan. The tract business, which is important to residential mortgage lending, is normally not available. Instead, origination resembles the residential spot business as satisfied builder-developers return for additional or new financing. Income property borrowers tend not to remember who helped finance their last deal. If your competitor is quoting rates an eighth or a quarter point lower, they will probably get the business.

The feasibility stage usually follows in which the mortgage lender analyzes the data to determine if a proposed transaction is possible. The format is much like the method previously suggested.

Assume a transaction looks like a deal that can be structured and placed. At this stage you will take an application from the borrower and the lender may also require a good faith deposit of 1 or 2 percent of the amount sought. In addition to showing that a borrower has some cash to begin the project, this deposit prevents the borrower from shopping a commitment - that is, trying to get one at a lower interest rate or for a longer term. A broker may earn a fee when a commitment is obtained from a permanent lender according to the application, irrespective of whether the borrower accepts it.

The *capitalization rate* and the *constant* are figures that can be used as pawns in negotiations with a lender. A permanent lender may require a high capitalization rate an be willing to trade a longer mortgage term for it, or the borrower may want a lower constant and be willing to accept a higher interest rate in return. All factors should be negotiable, as long as both parties feel protected. A lender who insists on getting as much out of a loan as possible may end up being the owner of something he does not want.

All supporting data and documentation should be submitted to the lender in a carefully prepared loan submission.

PERMANENT MORTGAGE INVESTORS

Four main groups of lenders hold approximately 84 percent of all long-term mortgages on income-producing real estate.

All lenders are concerned and motivated by return on and return of investment. *Return on investment* is the interest that is charged for the use of the money for the term of the loan. This interest rate is determined by the marketplace and the risk involved. *Return of investment* is the repayment of the principal and is of primary concern to a mortgage investor.

As a lender reviews a potential loan, he is concerned with the degree of risk involved, because the risk element will affect the interest rate. If the risk is high, probably no interest rate will balance it, but if the risk is only moderate, a higher than normal interest rate may make the investment attractive. At this point, a lender would have to decide if the higher interest rate might jeopardize the basic deal and force foreclosure in the future.

APARTMENTS

LOAN-TO-VALUE RATIO

Ratio generally 75-80% of economic value. Therefore, on proposed rather than existing project an 80% loan to economic value may be 85 to 90% of the actual costs. Generally speaking, to make a project economically feasible the actual hard costs (land, brick and mortar, construction loan interest, *etc.*) should not exceed 85% of the economic value of the project. We are imputing a 15% profit to the builder, developer, entrepreneur.

RATE

In the present market, generally 10% to 25%. In some instances a "kicker" or equity participation is necessary today to entice lenders on some difficult or "special use" project.

TERM

Generally from 25 to 30 years, unless you are dealing with older properties.

BUILDING REQUIREMENTS

Avoid buildings with open entrance balconies (motel-like). Layouts should be conventional and efficient. Bath access must be off a corridor or hallway; never through a kitchen or bedroom. Soundproofing is becoming a highly significant factor. Likewise, air-conditioning is becoming a must. As a minimum, air-conditioner sleeves must be provided. Adequate on-site parking -- not less than one for one and preferably more. Any building of more than two stories (except the sunken "garden-level" type) must have elevator service. Avoid kitchens that are wide open to a living room. Room and unit size minimums vary among lenders, but, generally speaking, the following should be considered minimal norms:

Efficiency Unit	-	400 Square Feet
1 - Bedroom Unit	-	600 Square Feet
2 - Bedroom Unit	-	850 Square Feet
3 - Bedroom Unit	-	1,050 Square Feet

Living rooms should have no less than a 12-foot width and no less than 220 square feet. "Pullman" type kitchens are acceptable only in efficiency units. No bedroom should be less than 9 feet wide. The master bedroom should have at least 140 square feet. 120 square feet for the second bedroom and 110 square feet for the third. Corridor width should be 5 feet or wider. Adequate storage and laundry space must be provided in the building.

LOCATION REQUIREMENTS

All lenders prefer an established apartment neighborhood, close proximity to public grades and high schools and to churches and parochial schools. Proximity to public transportation and to shopping facilities also are important requirements. Disqualifying location factors include any non-harmonious use in the immediate neighborhood such as a factory, warehouse, shopping center which might be too close (noise, traffic, lights, *etc.*), close proximity to railroad lines, neighborhood in racial transition, *etc.* In addition, be cautious to watch for overbuilding, usually evidenced by unusually high vacancy ratios in competing buildings. Avoid sites on very busy traffic thoroughfares.

OCCUPANCY HOLDBACK

Some lenders will issue a dual commitment on a proposed project, providing for a loan of a certain amount (the "floor") regardless of occupancy status at time of building completion and also providing for a higher amount (the "ceiling") subject to specific occupancy requirement. The difference between these two amounts is the "holdback." Most occupancy clauses require that 75% to 80% of the units be rented (at rentals projected in the appraisal) on 1-year leases. The amount of the holdback varies from 15% to 20% of the ceiling amount. For construction lending, the bank will consider such a commitment firm only in the floor amount.

PERSONAL GUARANTEE (CO-ENDORSEMENT)

Personal guarantee might be required in some cases. Few lenders will consider apartment loans without them. It depends on the lender, the loan to value ratio, and the general acceptance of the deal. Savings and loans usually do not require personal guarantees.

MISCELLANEOUS

Avoid furnished apartments, but where they are furnished, obtain a chattel mortgage on the owner's equity in such furniture, furnishings and equipment. Also appraise the property as though units are not furnished because most lenders can lend only on real estate, not on personal property. Likewise, obtain a first lien on ranges, refrigerators, carpeting, draperies and air-conditioner inserts where such items are included in the appraised value upon which the loan is based. Otherwise, lenders are satisfied with a lien only on the owner's equity in those items. There is a "gray area" as to whether these items are real estate or personal property. For that reason, even though the lender covers them with the first real estate mortgage, they also cover them with a chattel mortgage or Unified Commercial Code (U.C.C.) Security Agreement. Some investors will include them in the appraisal and lend on them; most others will not.

VALUATION

A quick rule of thumb for value is 10.0 times Net Income before Debt Service. In some cases, where real estate taxes are somewhat lower than other areas, or in the case of townhouses where the tenants pay all utilities and there is little or no public area for the owner to heat and maintain, value could be determined as 7 to 8.5 times gross annual income.

Another way to check it is to take the gross income of a project, deduct 43% for vacancy and expenses, take the remaining 57% as Net Income before Debt Service, then *capitalize* or divide the net income by 10%.

EXAMPLE

Gross Annual Income	$100,000
Expenses and Vacancy	43,000
Net Income	$57,000

57,000/10% = $570,000 value
x 80% loan
$456,000 mortgage

$456,000 mortgage = 4.56 times gross income. This is called a Gross Rent Multiple to Mortgage. The value of $570,000 is 5.7 times the gross income and is called the Gross Rent Multiple (GRM).

Obviously, expenses and vacancy factors will vary somewhat from area to area, especially real estate taxes. It is *imperative* that you learn and study your own market. A local MAI appraiser or property management firm in your area can assist you in this. The capitalization rate also will vary from lender to lender. Some will be below 10% and others above 10%. Naturally, the higher the capitalization rate, the lower the value.

Further checks you should make on the question of value and the loan to value would be the amount of loan as it relates to the gross square footage area of the building, and the number of units in a building.

EXAMPLE

> $1,500,000 loan/100 units = $15,000 per unit.
> (This is typical.)
> 85,000 gross square feet in the building:
> $1,500,000/85,000 = $17.64 per square feet of gross building area.

REQUIRED EXHIBITS

1. *Appraisal Report*. If none is available, then detailed data on at least 4 specific comparable land sales and detailed data on competing rentals in at least 4 other nearby projects (explain size of unit, number of bedrooms, utilities and services furnished, appliances included, carpeting, air-condition, parking, etc.)
2.*Two sets of plans and specifications*. Be sure dimensions are shown and that a plot plan, with dimensions, is included. If the project is existing, it is still often possible to secure an old set of plans. If not, furnish a Plat of Survey and a floor plan sketch. Plans are easily available from Title Companies.
3. *Current credit reports and signed current financial statements on the borrower*. If the borrower is a corporation, credit and financial statements on both the corporation and its major principals must be furnished.
4. *Map(s),* keyed to show property and its relation to downtown, schools, shopping, comparable apartment rentals and comparable land sales.
5. *Set of good color photos* showing property (even if vacant land), street scenes to right and to left, across the street, schools, shopping center, competing units and anything else of significance. These should preferably be mounted, 2 to a page, with typewritten description beneath each photo.
6. *Aerial photos* if readily available at reasonable cost.
7. *Detailed description of the project*; including its unit number, mix, size, features; the buildings gross area and net rentable area; the building amenities: including laundry rooms, storage facilities, pool, recreation room, tennis courts, garden area and walkways ("greenbelt"); the site size and features; the parking areas; the proposed ("*pro forma*") construction costs; and the proposed operating income and expenses. This should be from the borrower as well as the appraiser, if possible.

APARTMENT LOAN UNDERWRITING GUIDELINES

Apartments have assumed an increasing share of the housing market in recent years, and renters have become much more sophisticated in their requirements. There is also a pronounced trend toward larger apartment complexes in order to achieve the maximum efficiency in development and management costs, and economically provide the currently popular amenities, such as swimming pools, tennis courts, putting greens, club and recreation rooms, and sauna baths.

FEASIBILITY

Determination of the feasibility of any particular apartment project is based on an examination of the local economy and rental market, then determining if the project fits the requirements and limitations of the market, and further determining if the project can be absorbed within a reasonable time under current and potential future competitive conditions. The growth factor of the local economy is an important consideration, as well as the appropriate rental range, the "mix" in type of units, the required amenities, and the nature of the competition. The number of units in an apartment project is significant with respect to the size of the local market, and the typical project should be scaled for initial absorption within six months to one year maximum. In those cases involving 100 to 150 units and above, phasing should be considered, with subsequent phases dependent upon a realistic level of rental achievement.

Proposed and new modern two-story, garden-type projects are generally the most desirable and feasible type of apartment submission. Older apartments (unless modernized) often are not competitive. The high-rise apartment building has its own peculiar problems of acceptance in the local market, arising from two characteristics; the normally higher construction costs and operating expenses necessitating a higher rental scale than similar garden-type units; and the difference in the nature and outlook of the tenants due to the different life style involved. High-rise apartment construction has generally been limited to those high-density areas, such as close-in locations in larger cities, where very high land costs dictate this type of construction. Local acceptance of the high-rise concept should be investigated before entertaining a submission on this type of property.

LOCATION

The importance of a suitable location for any apartment complex has been stressed repeatedly, and it is a prerequisite to most other considerations in evaluating an apartment proposal. A location in an established apartment area with the proposed rental schedule in the same rental category as the existing units is desirable, but sites in newly developing residential areas in the logical line of growth are acceptable, as long as they do not involve "pioneering" too far ahead of the market. Reasonably convenient highway access to sources of employment and shopping areas is also necessary. The quality and nature of the surrounding development should be compatible with the apartment development being considered.

SITE
The site should be adequate in size and configuration to accommodate the improvements without overcrowding, and provide adequate space for on-site parking and the common area amenities. A minimum of 1-1/2 parking spaces per apartment should be required, and 2 spaces per apartment is recommended in most suburban areas. The topography should be reasonably adaptable to the layout of the improvements, and provide convenient access to the public street and highway network. Adequate drainage and availability of all normal municipal utilities is necessary. The nature of the immediately surrounding development is crucial, particularly in the case of small interior sites.

IMPROVEMENTS
The style and aesthetic appeal of an apartment project is becoming increasingly important, and the quality of construction must meet reasonable standards and building codes. (The FHA Minimum Property Standards are the basic guidelines.) Soundproofing is particularly important, with staggered stud or soundboard laminated walls between units and soundboard subflooring or spring clip-suspended ceilings being the minimum acceptable. Lightweight concrete subflooring in combination with wall-to-wall carpeting is the best soundproofing arrangement between floors currently in common use.

Room arrangement should be functional with reasonable zoning of living, utility and sleeping areas. Apartment sizes will vary considerably, depending on local competition and rental category, but generally one-bedroom units of 600 square feet, two-bedroom units of 850 square feet, and three-bedroom units of 1,050 square feet are a practical minimum.

LAND VALUE & CONSTRUCTION COSTS
Construction cost per square foot of living area is a local factor dependent upon labor and material costs, and the quality of construction. $18.00 to $21.00 per square foot for the "bricks and sticks" alone generally covers the current range of submissions. This factor can best be verified through local appraisers and contractors, or be reference to one of the building cost calculator systems. While borrowers cannot rely on this approach as heavily as the economic approaches, it is a means of checking on the validity of the other two appraisal approaches, and should reasonably correlate with them.

A very wide rage prevails in land value per apartment unit, depending on site conditions and the local real estate market. Land value ranging from $1,000 per unit in smaller communities or outlying and relatively underdeveloped suburban areas to $7,500 per unit the more desirable locations in built-up areas of major cities are typical. A competent appraiser will be able to verify the appropriate figure by citing comparable in the market areas of the subject property.

SOURCES OF INCOME

The primary income source of an apartment project will, of course, be the individual tenant rentals. However, supplementary income from Laundromats, covered parking, and retail and service shops which are part of the apartment complex will be considered within reasonable amounts, where the reliability of the income can be demonstrated.

The most significant basis of comparison between competitive apartment projects is rental cost per square foot, and per unit, per month. Since apartment rent levels are strictly a local competitive factor, it is essential that a number of the comparable in the market area be substantiated and outlined in the appraisal or elsewhere in the submission.

VACANCY

Even in a very favorable rental market, a nominal figure of 5% is usually applied to cover the continuing turnover vacancy and collection losses in a typical apartment project after the initial rent-up period. (The market may be exceptionally strong at the present time, but with term of apartment loans up to 30 years, the vacancy will probably average out to at least 5% during the term of the loan.) 10% to 15% or more may be applicable in student or seasonal-type units. A cushion for vacancies in excess of the normal rate is advisable. These may occur periodically for a variety of reasons ranging from rejection of the project due to competitive disadvantages to general overbuilding in the market area.

The most serious problem in determining apartment vacancy situations is the periodic overbuilding cycle. In practically all areas of any significant apartment development, the market is overbuilt from time to time, resulting in abnormally high vacancy rates even in sound well-conceived apartment projects, due to the excessive competition. This condition will normally require from six months to two years or more for correction, dependent upon the area's growth rate and other factors. Short of taking into account the current volume of apartment construction, little can be done to guard against an overbuilding situation occurring anywhere in the future.

However, it is essential that current vacancy rates be checked to the extent of available information. Generally, overall vacancy levels of under 5% indicate a favorable market, 5% to 10% is evidence of a softening market, and over 10% vacancy is normally sufficient to avoid consideration of apartment projects until the situation improves. Local offices of the National Apartment Association, the FHA, the Real Estate Board, the Chamber of Commerce, utility companies, major real estate lending institutions, and various other firms and agencies involved in the housing field are helpful in determining vacancy rates.

EXPENSES

Expenses, including minimal replacement reserves of 5% of Effective Gross Income, will vary considerably, depending upon local factors, particularly the real estate tax structure. A base figure (excluding taxes) of 20% to 25% of effective gross income is generally applicable, with real estate taxes ranging anywhere from 10% to 20% additional, 15% being about average in

Southern California. If the landlord does not pay for all or most of the utilities (including heat), 2% to 4% should be deducted from the expense percentages.

APPRAISAL
Since the economic and cost factors of an apartment project are determined locally, the provision of a competent and complete independent appraisal, setting forth specific rental comparable information and detailed calculations in the physical and economic approaches to value, is absolutely essential. A complete and reasonably detailed set of building plans and specifications is also essential in valuating any project which is under construction or proposed. They are also helpful in competed projects, if they are available.

Value by a capitalization of net income before debt service is generally considered to be the most reliable of the three approaches to value for income-producing properties, provided that realistic rental and expense figures have been used in determining the net income. A capitalization rate range of 9.5% to 10.5% is generally applicable at present, depending upon the interest rate and the stability of the income stream.

Particular caution should be used in determining the value of those apartment projects being sold on a syndicated basis. Such sales often involve unsophisticated purchasers, and the sale price may be substantially inflated. The best safeguard in this situation is insistence upon a reliable and independent local appraiser.

MANAGEMENT
The managerial ability of the borrower is an intangible consideration involving a judgment based on analysis of information on the individual's background. To facilitate this analysis, a detailed resume on each of the principals is helpful and should be included with each submission. Often it is indicated that professional apartment management will be hired, but this is considerably less desirable than having owners with demonstrable management ability and experience. The borrower's ability to manage, build or "pay" *must* be verified with local lenders, real estate brokers and suppliers.

FINANCIAL ANALYSIS
The borrower's financial capacity must be evaluated in relation to the magnitude of the project, and the required balance sheets and profit and loss statement should be supplemented by any necessary clarification. There are no hard and fast rules applying to the borrower's financial circumstances, and lenders tend to look strongly to the real estate in the underwriting of apartment cases. The borrower, however, should be able to demonstrate the availability of funds or other equity sufficient to adequately supplement the balance sheets and profit and loss statement should be supplemented by and necessary clarification. The borrower should also be able to demonstrate the availability of funds or other equity sufficient to adequately supplement the first mortgage in completing the construction of the project and sustaining it through a reasonable initial rent-up period or through building or operating cost increase periods.

CREDIT RATING
It is usually a comparatively simple matter to determine a borrower's credit status by obtaining credit reports and/or checking personally with the borrower's business and financial contacts. If a pattern of serious credit difficulties or questionable ethical standards unfolds, then it is advisable to terminate any further consideration of the project *regardless of the merits of the proposal otherwise*. "Garbage in -- garbage out."

RULES OF THUMB
The evaluation of apartment loan transactions, in common with all commercial real estate situations, requires the exercise of judgments based on the particular circumstances of each case, and cannot be reduced strictly to conformity with any system of formulas or mathematical ratios. However, there are a number of meaningful comparisons and ratios which are applicable in determining the acceptability of an apartment submission. Those most commonly applied are as follows:

Loan-to-Value Ratio	=	Mortgage / Value	=	75% to 80%
Debt Service Coverage	=	Net Income Before Debt Service / Debt Service	=	1-1/4 times
Default Ratio	=	Debt Service & Expenses / Gross Income	=	80% to 85%
Loan per Unit	=	Mortgage / Number of Apartments	=	$15,000 to $30,000
Gross Income Multiplier	=	Gross Income x Multiplier = Value	=	7 to 8-1/2times
Loan Per Sq. Ft.	=	Mortgage / Sq. Ft. of Improvements	=	$15 to $30

Average Vacancy & Collection Loss Factor			=	5% of Gross Income
Average Expense Ratio			=	35% of Gross Income after Vacancy of 5%
Average Overall Capitalization Rate			=	9-1/2% to 10-1/2%
Mortgage Multiplier	=	$\frac{\text{Mortgage}}{\text{Gross Income}}$	=	5 to 6 times

SUMMARY
Much of the foregoing information is very general in nature, but most of the apartment lenders' process falls into the above categories. The loan amounts per unit or per square foot could change considerably if higher costs and higher rentals are substantiated. The ratios, however, for Loan-to-Value, Debt Service Coverage and Default Ratio are not as subject to change because of higher construction costs or rentals.

From time to time, market conditions in any particular location or city will vary. Rather than decline all apartment submissions from those areas or cities where overbuilding exists, look at each property on an individual basis, and require increased feasibility, management, and financial strength. Loans in these areas will be more conservative. A sample apartment analysis follows, which will demonstrate the ratios we use in underwriting apartment loans, as well as apply the aforementioned "Rules of Thumb."

SAMPLE APARTMENT ANALYSIS

PROPOSED
50-unit Garden Apartment Project (two-story, non-elevator) of 50,000 gross square feet with a pool, sauna and recreation room. Situated on 1-1/2 acres of land (65,340 square feet). Two parking spaces per unit included with rent. All units are two-bedroom, on bath, living room, kitchen, patio - 900 square feet. Land recently purchased for $200,000. All units are individually metered for utilities, except water.

COST ANALYSIS

Construction Costs (units only)	
($18.00/square foot X 50,000)	$ 900,000
Pool, Sauna, Recreation Room	1,000,000
Legal, Accounting, Closing, Escrow	20,000
Taxes and Insurance During construction	10,000
Architectural (Design and Supervision)	30,000
Appraisal, General & Administrative	10,000
Financing Fees (4% x $1,300,000)	52,000
Construction Loan Interest	
$1,300,000 x 9 3/4% x 12 mo. X 50%)	63,375
Contingency (3%)	40,000
Subtotal	1,225,375
Land (at cost)	200,000
Subtotal	1,425,375
Developer's Overhead and Profit (15%)	210,000
Total	$ 1,635,375

ECONOMIC ANALYSIS

50 units @ $450.00/mo. (50¢/mo. per sq. ft.)		=	$22,500/mo.
Laundry Income (@ $5.00 unit/mo.)		=	$250/mo.
Gross Income Yearly:			
Units: $22,500 X 12			$ 270,000 (99%)
Laundry:$250 X 12			3,000 (1%)
Total:			273,000 (100%)
Less: Vacancy and Collection Loss (5%)			13,650 (5%)
Effective Gross Income:			259,350 (95%)
Less: Operating Expenses:			
Real Estate Taxes (15%)	$ 41,000		
Insurance	2,500		
Water ($10/unit/mo.)	6,000		

Other Landlord Utilities	12,000		
Maintenance & Gardener	10,000		
Management (5%)	13,650		
Reserve for Replacement (5%)	13,650	98,800	(36%)
Net Income before Debt Service:		$ 160,550	(59%)

RATIO ANALYSIS

Capitalized Value	Net Income Before Debt Service/Capitalization Rate 160,550/10.0	=	$1,605,500.00
Debt Service	Mortgage Amount x Yearly Constant (here 9-1/2% @ 30 years = 10.10 constant) 1,300,000 X 10.10	=	$131,300.00
Debt Service Coverage	Net Income Before Debt Service/Debt Service 160,550/131,300	=	1.23 times
Loan-to-Value	Mortgage Amount/Capitalized Value 1,300,000/1,605,500	=	80.0%
Loan Per Unit	Mortgage Amount/Number of Units 1,300,000/50	=	$26,000.00
Loan per Square Foot: Gross	Mortgage Amount/Gross Building Area 1,300,000/50,000 square feet	=	$26.00
Loan per Square Foot: Net Rentable	Mortgage Amount/Net Rentable Square Feet 1,300,000/45,000	=	$28.89

Breakdown Ratio	Operating Expenses + Debt Service ¸ Gross Income 98,800 + 131,000/273,000	=	84.3%
Gross Income Multiplier	Capitalized Value/Gross Income 1,605,500/273,000	=	5.9 times
Mortgage Multiplier	Mortgage Amount/Gross Income 1,300,000/273,000	=	4.8 times
Building Efficiency	Net Rentable Area/Gross Building Area 45,000 sq. ft./50,000 sq. ft.	=	90.0%
Return On Equity	Net Income Before Debt Service - Debt Service/Owners Equity (or Cash Equity) 160,550 – (131,300/335,375)	=	8.7%

(Equity is Cost or Purchase Price minus Mortgage Amount; here we use Total Cost less Mortgage Amount)

INTRODUCTION TO DEBT-TO-INCOME RATIOS

The debt-to-income ratio is a key factor in the analysis of a loan application. In order to process a large volume of applications, the real estate industry has standardized income analysis.

The first step is to analyze all monthly debt of the prospective borrower. The calculations must include an estimate of the payment for the pending loan request so that it can be included in the monthly debt.

When total monthly debt is divided by total monthly income, the resulting ratio will determine if the applicant will qualify for conventional debt. Generally, FNMA, GNMA and most other federally-sponsored lending programs allow a maximum of a 36% debt-to-income ratio (33% with PMI). Applicants who do not have a qualifying ratio may still be able to borrow, however, they will probably be funded through non-conforming sources at a higher rate of interest.

In an effort to maintain a low interest rate, your borrower may choose to lower the amount of the request or consolidate other payments over a longer term which will lower monthly debt and, in turn, lower the debt-to-income ratio.

The debt-to-income ratio analysis is an important pre-requisite for screening your prospect. Be sure to make this analysis at your earliest opportunity during the negotiation stage. Verifications of the information will be required by the lender, so be sure the information is accurate at inception.

EXAMPLE
DEBT-TO-INCOME RATIO CALCULATION

$100,000 2ND T.D. @13% FOR 15 YEARS FULLY AMORTIZED. PAYMENT: $1,265.25 PER MONTH

DEBT

1ST T.D. PAYMENT	$1,084.00
+ TAXES: $195.00 + INSURANCE: $35.00	= $ 230.00
2ND T.D. PAYMENT OF PENDING LOAN REQUEST	$1,265.25
AUTO LOAN $441.38 + 389.40	= $ 830.78
OTHER (DESCRIBE)____	$_______
OTHER (DESCRIBE)____	$_______
OTHER (DESCRIBE)____	$_______
TOTAL MONTHLY DEBT	$3,410.03

INCOME

GROSS MONTHLY SALARY	$3,600.00
CO-BORROWER GROSS MONTHLY SALARY	$3,000.00
DIVIDEND OR INTEREST MONTHLY INCOME	$_______
OTHER (DESCRIBE): OVERTIME: $400.00	
RAISES: $1,231.00	$1,631.00
TOTAL MONTHLY INCOME	$8,231,00

TOTAL MONTHLY DEBT: TOTAL MONTHLY INCOME

$3,410.00 / $8,231.00 = 41.4%

INTRODUCTION TO LOAN-TO-VALUE RATIOS
The loan-to-value ratio is important in determining the amount of the loan for which a borrower can qualify. Different lending institutions use different loan-to-value ratios. Generally, clients with adequate income and good credit history enjoy the highest loan-to-value ratios. Lenders may offer up to 90% of the value of a property. As credit worthiness becomes an issue, the loan-to-value ratio may drop to 50% or even lower.

The type of collateral also affects loan-to-value ratios. Single family residences which are conventional and saleable, usually, have the highest loan-to-value ratios. Commercial real estate, on the other hand, may have loan-to- value ratios from 75% to 50% or lower.

LOAN-TO-VALUE RATIO CALCULATION

LOANS ON SUBJECT PROPERTY

AMOUNT OF LOAN REQUEST	$__________
EXISTING 1ST TRUST DEED BALANCE	$__________
TOTAL LOANS ON PROPERTY UPON FUNDING	$__________

VALUE

TOTAL APPRAISED VALUE (OR ESTIMATED VALUE PRIOR TO APPRAISAL)	$___________

AMOUNT OF LOAN : AMOUNT OF VALUE
$________________ : $_________________ = __________%

SHOPPING CENTERS

LOAN-TO-VALUE RATIO
75% of value.

RATE
12.00 to 13.50

AMORTIZATION PERIOD
Traditional lenders will only go to the major less term(s). The theory here is that as long as there is a major tenant in occupancy the "satellite" stores can always be rented. Many lenders will go to 30-year terms even with 20-year major lease terms in order to be competitive.

BUILDING REQUIREMENTS
Nothing specific except that air-conditioning is required, and there must be paved, striped and illuminated parking at a 5 - 1,000 minimum ratio. This means 5 parking spaces for each 1,000 square feet of net rentable area. Accessibility to the center should be unobstructed. Enclosed malls are preferable to "strip" centers, particularly in areas where weather is a problem.

LOCATION REQUIREMENTS
In many cases, especially larger centers, the owner or the major tenants will secure a feasibility study (a trade area survey). If possible, get a copy. The most important location factor is density of population within the surrounding trade area. If no trade area survey is available, one should be made.

LEASING REQUIREMENTS
For the medium and large centers, before a loan proposal will be considered, there should be enough rental income assured from prime tenants on 20-year leases to cover 50 - 75% of debt service and operating expenses. Either signed leases or "letters of intent" to lease are satisfactory. For small centers, many small investors will finance centers that have major tenants covering less than 50% of debt service and operating expenses (this is called "coverage").

Generally avoid too many non-retail sales tenants because they do not attract a lot of "traffic" to the center. Examples of these are insurance agents, real estate brokers, plumbers, electricians or other service industries, including dentists and doctors. Also avoid having the "lead" or major tenant be a special purpose company. If it is unsuccessful, the center's traffic decreases and the smaller tenants cannot draw enough business to be successful. Examples here are sports centers, theaters, restaurants or stores that sell only one item like records, carpeting, furniture, automotive supplies or electrical appliances, *e.g.* stereos or refrigerators.

COST STRUCTURING

As a rule of thumb, a Shopping Center should cost between $24 and $37 per square foot to build, including all costs, for a Neighborhood Center. A Regional Mall Center will cost between $45 and $55 per square foot to build.

EXPENSE STRUCTURING

Most Shopping Center leases require the tenant to pay a fixed rental per square foot or a percentage of the tenant's gross sales, whichever is greater. In certain situations, with strong credit tenants, the tenant is allowed to deduct (or recapture) tax, insurance and common area maintenance payments from his gross sales before he pays his percentage. Most leases are absolute net. If they are not absolute net then the leases generally require the tenant to pay any increase in taxes over the "base" or first year ("tax stopped"); any increase in insurance costs over the base year ("insurance stopped"); and the tenants pro-rata share of utilities and common area maintenance costs. There is usually a "merchants association" which advertises for the center and the tenant is usually required to join this association. The tenant pays his own utilities and is usually provided only with the building "shell." This means the tenant fully improves the inside of the store at his own cost (or pays the landlord increased rent, including 10% "interest" over the life of the lease to compensate for the landlords providing the "tenant improvements").

When preparing your Economic Analysis take a 5% Vacancy and Collection Loss on the local tenants only; a 1% Management Fee on the Majors and 3% on the Locals; and a $0.05 per square foot Structural Maintenance figure.

UNDERWRITING

To increase the loan value of the center the major credit's income may be listed separately from the local tenants' income. A lower capitalization rate then can be applied to the major credits income (like a 9.0) while using a higher capitalization rate (like an 11.0) on the local stores' income. Some borrowers are financing the major credits separately from the locals. They will obtain a "prime credit" loan from a credit lender on the major tenant and a different, higher rate and more conservative loan from a different lender on the local tenants. This is hard to do since the lender knows that if the major tenant leaves, the center typically is doomed and the lender wishes some control over the majors.

Many centers have a restaurant free-standing away from the other stores, typically at the end of the parking lot next to the busy street. This maximizes use of the parking lot and rent on these desirable "out-lots" is substantially higher than inside the center.

A Local or Neighborhood center can expect a $24 - $37 per square foot loan, which typically is 100% of the cost of an proposed or newly built center. A Regional Mall can expect a loan of $45 - $55 per square foot, likewise 100% of the building costs of today's center.

DEFINITIONS

LOCAL OR SPECIALTY SHOPPING CENTERS	A smaller center with only local tenants. Typically 25,000 - 50,000 square feet.
NEIGHBORHOOD SHOPPING CENTER	A medium size center between 50,000 - 250,000 square feet. Typically the "anchor" or "lead" tenants are a Supermarket and a Drug Store.
REGIONAL SHOPPING CENTER (MALL)	One with 250,000 to 1,000,000 square feet. Typically anchored by Sears, J.C. Penny and a Supermarket.
PERSONAL CO-ENDORSEMENT	Not usually required.
VALUATION	Figure value at about $20 to $30 per square foot of building area (this should cover all building costs including paving, indirect costs, *etc.*), then add land value. Another rule of thumb (very rough) is to figure value at 9 times gross annual income.

EXHIBITS REQUIRED	Same as for Prime Credit deals.

OFFICE-WAREHOUSE

DEFINITION

A building containing 10% to 15% offices in the front with unobstructed and undivided warehouse, storage or light manufacturing space adjoining the office. The office portion may be one-story; however, the warehouse portion will be typically 16 to 18 feet high with no obstructions on the floor or up to the ceiling. The warehouse portion will have several 14 feet by 14 feet overhead doors leading to truck loading platforms or areas. The site will have adequate off-street parking (1,000 to 2,000 feet) and will allow easy passage of large trucks.

LOAN-TO-VALUE RATIOS

Ratio generally 75% of economic value. Loans are generally in the range of $13 to $15 per square foot. The lender will require a 1.25 debt service coverage.

AMORTIZATION PERIOD

Generally 25 to 30 years unless you are dealing with older properties.

BUILDING REQUIREMENTS

Minimum 14 feet "clear under beam" of height unobstructed in warehouse portion. Require 1 parking space for each 500 square feet of warehouse and for each 250 square feet of office. 14 feet high and wide overhead truck loading doors in warehouse and easy passageway for large trucks on the site. Office space relatively conventional and facing the street so that there can be company identification on the door of the building facing the street. At least one man's and one woman's bathroom typically near the door opening from the office to the warehouse portion. The modern buildings have either steel "beams" or "glue-laminated" and fireproofed wooden beams as the ceiling supports in the warehouse. The office frequently have a second floor opening onto the warehouse portion as extra mezzanine storage area.

The building should be completely multi-purpose with virtually no special features except heavy electrical availability and/or extra thick floors.

LOCATION REQUIREMENTS

Established office-warehouse or industrial area, preferably in a modern industrial "park." Site should have easy access to major highways.

VALUATION	A rule of thumb is to capitalize Net Income Before Debt Service by a 9-1/2 to 10 capitalization rate. The building should cost $12 to $14 per square foot to build, then add the land value to determine the cost valuation. Since the landlord typically pays only structural maintenance and first year taxes and insurance, operating expenses and vacancy are usually 20% to 25% of gross income.
PERSONAL CO-ENDORSEMENT	Generally required.
INTEREST RATES	Typically 12-1/2% to 14% today.
EXHIBITS REQUIRED	Same as for apartments except including a copy of the executed or proposed leases and detailed financial information on the tenants, if available.

GENERAL OFFICES (MULTI-TENANCY)

LOAN-TO-VALUE RATIO	70% to 75% of economic value. The lender will require a 1.20+ debt service coverage. Loans are generally $25 to $35 per square foot.
RATE	12% to 13-1/2%.
AMORTIZATION PERIOD	Generally 25 to 30 years.
BUILDING REQUIREMENTS	No specific rules. On-site parking should be adequate, which means 100 to 250 square feet (except for downtown buildings). Building should be of a general purpose nature, suitable for occupancy by any typical office space user. Air conditioning is essential. Any building with more than one story must have an elevator. Hallways should not be too wide and bathrooms must be readily available.
LOCATION REQUIRE-MENTS	As established office building neighborhood, close to public transportation and on a major cross street.
VALUATION	A rule of thumb is to capitalize Net Income Before Debt Service by 9.5 to 10.0 capitalization rate. The building should cost $35 to $45 per square foot to build, including the land, unless it is a downtown location. The landlord typically pays for all utilities but the tenants pay increases in taxes, insurance and maintenance costs over the first (base) year. Rental rates are typically 60¢ to 75¢ per square foot monthly in the suburbs and 75¢ to $1 per square foot monthly in a "downtown" high rise location. Operating expenses plus vacancy average 35% to 45% depending on the real property tax structure of the area. Office buildings should be no less than 90% efficient.
PERSONAL CO-ENDORSEMENT	Generally required, unless there are a high percentage of long-term leases with good tenants.
LEASING REQUIREMENTS	Most lenders will issue a "floor-ceiling" commitment similar to the holdback for occupancy as used in apartment lending. Lenders will also "hold back" $10 to $15 per square foot for unfinished office space, since that is typically what it costs to finish

	the space. It is preferable that there be some leases or letters of intent to lease so that a rental rate pattern can be established.
EXHIBITS REQUIRED	Same as Office-Warehouse

MEDICAL OFFICE BUILDINGS

DEFINITION	An office building designed specifically for use by doctors, dentists and related medical service suppliers (laboratories, X-ray, psychologists, speech therapists, *etc.*). Medical offices have many more sinks and heavy electrical availability. The larger buildings will have a pharmacy and coffee shop on the street level, while smaller buildings have such facilities nearby.
LOAN-TO-VALUE	75% of economic value. The lender will require a 1.20 RATIO debt service coverage. Loans are generally \$50 to \$65 per square foot.
RATE	12% to 13 3/4%. Lenders prefer owner-occupied or doctor-owned medical buildings.
AMORTIZATION PERIOD	Generally 25 to 30 years.
BUILDING REQUIREMENTS	If the building has more than one story, it requires an elevator adequate to carry a patient on a stretcher. On-site parking minimum of 10 cars per doctor. Air-conditioning is essential and the building should be suitable for occupancy by any typical doctor.
LOCATION REQUIREMENTS	Preferably near a hospital or in an established "downtown" medical office location unless small owner-occupied building. Building should be on a major street with public transportation facilities.
VALUATION	Use 9 1/2 to 9 3/4 capitalization rate on the Net Income Before Debt Service. The building should cost \$60 to \$70 per square foot to build, including the land value, unless it is a "downtime" location. The tenant typically pays all utilities and increases in taxes and insurance over the first (base) year. Rental rates are typically \$1 to \$1.10 per square foot monthly in the suburbs and \$1.15 to \$1.25 per square foot monthly in a "downtown" high rise. Operating expenses plus vacancy average 30% to 40% depending on real property taxes. Remember, doctors are very sensitive to being treated nicely, so building services are essential.

PERSONAL CO- ENDORSEMENT

Doctor owner-occupants must either guarantee the loan or personally lease office on long leases. Non-doctor owners generally must guarantee the loans.

LEASING REQUIREMENTS

Most lenders will issue a "floor-ceiling" commitment similar to the hold backs of occupancy as used in apartment lending. Lenders will also "hold back" $15 to $20 per square foot for unfinished medical office space since that is typically what it costs to finish it. It is preferable to have leases to establish the rental rate pattern.

EXHIBITS REQUIRED

Same as Office-Warehouse, except biographical resumes on the doctor owner-occupants are essential.

MOBILE HOME PARKS

DEFINITION

A developed area where residents rent space on a semi-permanent basis for their Mobile Home "coaches." The project appears to be a cluster of single story free standing metal apartments. Each Mobile Home pad typically has its own paved patio and is covered by gravel or crushed stone. Many parks are situated adjoining a mobile home coach sales facility typically owned by the park's developer.

LOAN-TO-VALUERATIO

Generally 65% to 70% of value. Lenders use a 1.40 debt service coverage and will capitalize net income before debt service at 1% over the mortgage interest rate.

RATE

Generally 13 1/4 to 14 1/4 today.

AMORTIZATION PERIOD

20 to 25 years.

BUILDING REQUIREMENTS

Mobile Home Parks are rated by a service called "Woodalls." A high quality park will have a "Four or Five Start" rating. Parks should have all underground utilities to each pad ("hookups"). Generally the park has one main entrance for better control of ingress and egress. The park should be served by a main street and nearby schools and shopping.

Five star parks generally have a density of no more than 7 pads per acre. Each "single wide" coach pad should have not less than 3,600 square feet. A "double wide" coach pad should have 4,000 square feet. The pads typically have a 180 square foot paved patio and are covered by crushed stone or gravel to control weeds and minimize maintenance. Off street parking for two (2) cars per pad is minimum.

The park itself will generally have a combined office and recreation room along with a children's playground, pool and car wash area. Better parks have tennis courts, exercise facilities and a recreational vehicle parking area. If the park allows both couples with children and adults only they should be in separate areas.

LOCATION REQUIREMENTS	Access to schools, shopping and business. Parks are frequently located as buffers between residential and industrial areas of a city.
VALUATION	A rule of thumb is to use a 10% vacancy and collection loss and 35% operating expenses. Land costs generally run 15% to 20% of the total construction costs per pad. The typical cost per pad is $7,000 to $9,000 with loans averaging $5,000 to $7,000 per pad.
PERSONAL CO-ENDORSEMENT	Generally required.
EXHIBITS REQUIRED	Same as for apartments, except including detailed description of the park's manager since to be successful Mobile Home parks require highly skilled managers.

HOTELS AND MOTELS

LOAN-TO-VALUE RATIO

Ratio generally 70% to 75% of economic value. Loans per room vary from $6,000 - $8,000 for an "Economy" hotel without a restaurant to $12,000 - $15,000 for an urban location with a restaurant and modest convention facilities. The lender will require a 1.25 debt service coverage.

AMORTIZATION PERIOD

Typically 25 to 30 years

BUILDING REQUIREMENTS

Each geographic area has its own typical building design. Minimum parking ratios require 1.25 parking spaces per room not including parking for dining/meeting or cocktail facilities. In colder areas "outside" hallways are undesirable.

Soundproofing between rooms is important and a full bath should be required. An indoor pool in a colder climate is a necessity as are convenient lobby, cocktail and restaurant facilities. Efficient hotels have a minimum of 125 rooms with a restaurant and cocktail bar and 100 rooms for an Economy hotel without a restaurant.

Various services analyze and advise on a hotel/motel's feasibility. Perhaps the best known are Harris, Kerr, Forster and Company, Chicago, Illinois ("trends") and Laventhol, Krekstein, Horwath and Horwath, Chicago, Illinois ("Lodging Industry").

Both companies publish yearly area statistical review whose name is contained in the parentheses following the company name. These feasibility studies "make or break" the hotel/motel submissions.

Economy hotels cost between $20 to $25 per square foot, with the hotels with restaurants ranging from $25 to $35 per square foot.

LOCATION REQUIREMENTS

Downtown, airport or other "Destination" hotels are almost the only ones financeable today. Highway access is a must. A balance must be struck between being in a hotel area where there is "action" and an area which has overcompetition. Recreational area hotels are virtually unfinanceable.

VALUATION	Typical hotels do not break even until they attain a minimum 70% occupancy level. For hotels without a restaurant add approximately 10% to Effective Gross Income for income from telephones, laundry and vending machines. In a Motor Hotel presume 60% of Gross Income is from the rooms and 40% from restaurant, bar, telephone and laundry income. After Net Income Before Debt Service/Room Operations is determined subtract a "Rental Return from Furniture and Furnishings" of 10% per year for the cost of such items. This is to compensate for the high replacement cost of these items and because lenders like to determine what the real estate "alone" will produce. These are frequently financed separately but the lender requires a security interest on these items.
PERSONAL CO-ENDORSEMENT	Generally required.
INTEREST RATES	Generally 12% to 13 1/2%. Tough or otherwise marginal deals may require the lender to receive a "kicker" of 5% of gross income in excess of scheduled initial gross income.
EXHIBITS REQUIRED	1. Feasibility Study and Appraisal. 2. Site Plan, Floor Plan, Building Elevation. 3. Management Resume and Contract. 4. Construction Cost Breakdown, including Land Purchase Contract (new construction). 5. Income and Expenses (estimated on new construction). 6. Site Map and Aerial Photographs. 7. Owner/Borrower Resume and signed, current financial statements. 8. Details on the furniture and furnishings design and financing. 9. Resume and financial statements on the General Contractor (new construction).

NURSING HOMES

DEFINITION

A long-term residential health-care facility which provides one or more of the following services:

1. Room, board and social programs - this is called "Residential Care."
2. Assistance in walking, dressing, bathing and food preparation - this is called "Personal Care."
3. Full-time nursing and medical care - these typically are called either "Extended Care," "Intermediate Care" or "Skilled Nursing" homes.

All homes are licensed and categorized by the state or municipality. The terms described in paragraph 3 above refer to certification for eligibility to participate in various U.S. Governmental cost reimbursement programs. The primary federal programs are Medicaid (Title XIX) which assists low income people of all ages; and Medicare (Title XVIII) which assists persons over the age of 65.

A municipality must issue a "Certificate of Need" before a home may be licensed.

LOAN-TO-VALUE RATIOS

Ratio generally of 65% to 75% of economic value. Loans generally in the rage of $7,000 to $9,000 per bed. The lender will require a 1.5 debt service coverage.

AMORTIZATION PERIOD

Generally 20 to 25 years.

BUILDING REQUIREMENTS

Modern, efficient homes are generally over 100 beds. The site should have good access to public transportation (four employees) and visitor parking of one space per every (5) beds. Most homes are one-story with a central nursing station no further than 100 feet from the farthest patient bed. Each home should have its own laundry, dining and food preparation facilities even if such services are provided from outside the home. A "for-profit" or "proprietary home should not have an excess of non-income producing space such as chapels and visitors' lounges.

Homes cost typically $10,000 to $15,000 per bed including land. The cost of equipping the home is from $1,000 to $1,500 per bed. Equipment is typically financed separately on a short-term loan; however, the buyer or lender should obtain a security interest in the equipment.

Homes are required to have a licensed administrator and be fully staffed to comply with licensing requirements. Sophisticated continuing management is an absolute must.

LOCATION REQUIREMENTS

Preferably middle-class residential areas served closely by a hospital or doctor's office.

VALUATION

A rule of thumb is to use a 15% vacancy and collection loss and an overall 80% factor for operating expenses for a home providing nursing facilities. A residential care facility's expense ratio generally will be 75%. A home will usually need 12 to 18 months to "rent up" to 85% occupancy and an operating loss reserve should be underwritten into the costs. Capitalization rates average 2% over the interest rate.

PERSONAL CO-ENDORSEMENT

Generally required.

INTEREST RATES

Generally 12.5% to 14%, if loans are available at all from "conventional" lenders. Many homes are financed with FHA insurance.

EXHIBITS REQUIRED

Same as for apartments except detailed information on management and the Certificate of Need and supporting documents.

INTRODUCTION TO CONSTRUCTION LOANS

Every builder/developer is concerned with two types of borrowing: a short term or interim loan that carries the project through most or all of the construction, and a take out or permanent loan commitment the new owner will use to pay for the property.

CHARACTERISTICS OF A CONSTRUCTION LOAN

In the case of construction loans, the lender agrees to make the loan before there are any improvements upon the real estate, subject to plans and specifications that have been submitted. Since there are no improvements, this type of loan is probably one of the most hazardous that can be made. (However, if certain precautions are taken and rigid controls exerted, the construction loan can be a source of good income to the lender.) Of course, the major hazard is the inability of the borrower to complete the building because of possible lack of capital, delays caused by bad weather, material shortages, labor strikes, excessive losses through poor estimations of other jobs, or other such reasons.

In the case of the construction loan, two separate lenders are frequently involved. The first lender is the one making the loan for the construction of the improvements and the second is the final lender, who would advance the money for the purchase of the property to the owner after the construction is completed.

INTERIM FINANCING

The construction loan is usually referred to as an interim finance loan and the final loan as a take-out or final loan. It is not necessary in all cases for two lending agencies to be involved, since several agencies in California make both interim finance loans and take-out loans. National banks are allowed to make interim loans, and if the purchaser of the property meets their standards, they may also make the final loan. In the case of an owner-builder, the construction loan may become the final and only loan required by the bank.

The state banks of California are allowed to make the same type of loan, but under a slightly different ratio of loan to value and period of time as far as the construction term is concerned. State and national banks are limited to a maximum maturity of thirty years on a construction loan unless the loan is insured by an agency of the federal government, such as the FHA or the VA.

Savings and loan associations in California may also make construction loans on a interim basis or on a final basis, whether they are state or federally chartered.

The interim finance program is particularly beneficial to organizations located outside California or outside the lending area of the institution that will issue a commitment to make the final loan. Such interim loans benefit them because they know that the building they have approved from plans and specifications will be constructed on the proper lot under proper supervision, and will be available for their take-out loan upon completion. In this way areas with money to loan have been able to aid areas in which there has been a shortage of permanent real estate loan money; e.g. life insurance companies on the East Coast have been able to make satisfactory loans on property located on the West Coast. This practice has also been beneficial to California veterans who applied and received commitments from the Cal-Vet program. The Cal-Vet program was originally designed for Veterans of World War I.

In California, mortgage companies also make construction loans. The purpose for which the loan is made - *i.e.* whether it is to be held in the company's portfolio or sold to some insurance company for whom the mortgage company is acting as correspondent - will determine the amount it will loan toward the construction. If the mortgage company knows that it will sell the loan to an insurance company after construction is completed, then the maximum loan it will make will be 75% on homes and commercial buildings. On the other hand, should a company make a loan that it desires to keep in its own portfolio, there are no restrictions; the amount of the loan will depend upon the individual and the property.

INTERIM-FINANCE LOAN TERMS

State chartered savings and loan associations may make home construction loans with the same security and term as loans made on existing property. However, no loan for the purchase of land and construction of improvements may exceed 85% of the fair market value. The same is true for federally chartered savings and loan associations.

National banks may loan under home construction financing 80% of either the total appraised value or the acquisition costs, whichever is smaller, for thirty-six months. State banks may lend 85% of the appraised value of land and proposed improvement for thirty-six months. The mortgage company, as previously indicated, is unrestricted regarding such loans.

Much legislation has been passed to put state and national banks more in competition with savings and loan associations. Under the old program, which had a maximum of nine months' maturity for the national bank on a construction loan, it was impossible for the bank to make loans on the construction of large commercial buildings or, in some instances, large apartments units. State banks also were restricted to the extent that they were unable to compete with savings and loan associations. Today, however, with the eighteen month and thirty-six month construction loan allowed, both state and national banks can compete fairly well with savings and loan associations for the larger long-term construction financing.

As a rule, the interest rates are comparable to the take-out loan. Because of the additional hazards and the extra work connected with the construction loan, it has become customary for investors to make a service charge for these loans. This service charge has varied from 1.0 to 2.5 points or more in some instances. Broker fees will run 1.0% to 2.0%.

Most national banks feel that it should not take more than 120 days to complete a residence and therefore usually write their construction loans for home financing for a period not to exceed nine months, which is supposed to give adequate time for the home to be constructed and a buyer to be found. If the property is to be a duplex, much the same schedule will hold; however, if it involves large-scale construction such as apartment houses or commercial buildings, usually the note will be written for the maximum term. This practice also applies to state-chartered banks.

Savings and loan associations write their construction loans for the maximum period regardless of the type of building being constructed.

The loan-to-value ratios of various lending agencies have also been approaching equality. The national banks are now the lowest with an 80% ratio on residential loans; the state banks and the savings and loan associations have an 85% ratio.

APPLICATION PROCEDURES FOR CONSTRUCTION LOANS

In the case of construction loans, the applicant is usually the builder or the owner of the property. Sometimes the builder is also the owner, in which case the owner-builder almost always makes the application to the lender. If it is to be an FHA-insured loan, the application is for a conditional or a firm commitment depending upon whether the owner is to be the final occupant of the completed building or whether the property is to be available for purchase by an unknown individual at the time the commitment is made. The commitment might also be a firm commitment including a dual commitment; under these circumstances a firm commitment is made with the additional provision that if the builder is unable to find a purchaser within a reasonable time, he may take over the loan himself at the lower loan figure provided when the builder is building on speculation.

If the take-out loan is to be used, the applicant should also make provisions with the final lender to issue the take-out letter in the form of a commitment binding the lending institution to make the final loan after the building has been completed according to the plans and specifications submitted to the lender.

A developer who has demonstrated reliability and superior performance *and* who retains competent professional site planners, engineers, and architects; maintains a high level of construction quality; has a minimum of construction complaints and a record of prompt adjustment is a good candidate.

SOME ELEMENTS TO BE INCLUDED IN THE LOAN PACKAGE

1. A financial statement of the developer.
2. A credit report.
3. A bank appraisal of the property.
4. Copies of the preliminary approval of FHA (if applicable).
5. Copy of a preliminary title search.
6. A copy of the proposed plot plan.
7. Terms of the proposed lot release agreement.
8. Purchase agreement on land, unless already owned.
9. Cost breakdown of land improvements and copies of all major
10. An application for the loan.

DOCUMENTATION

The applicant for a construction loan should always have available for the lender a complete and detailed set of plans and specifications bearing the owner's and contractor's signatures, whether the loan is to be Federal Housing Administration, Veterans Administration, or conventional. Plans should be complete in all details, and specifications should also be complete so that when the inspectors examine the property for conformity to plans and specifications there will be no difficulty in determining whether the plans and specifications are being followed.

Accompanying the plans and specifications should be a builder's contract, indicating that the builder will furnish all materials and labor and complete the building according to the plans and specifications submitted or attached for a certain definite amount. This contract must be signed by the contractor, and it is desirable that his license number appear so that it will be easy for the lender to determine that he has the right to contract as a general contractor and that the license is valid and unrestricted. It will make the appraiser's job somewhat easier if the contract is accompanied by a cost breakdown sheet. When the applicant has all these documents he is ready to approach you to make his formal application. The application will contain the amount of loan desired, the length of time for which the loan is requested, and the schedule proposed for the repayment of the obligation. The application will, as usual, contain a financial statement of the applicant. If the contractor is unknown to the lender, you will probably request that your borrower obtain for the lender a recent financial statement and operation statement of the contractor.

It will facilitate matters if the application is accompanied by a description and photographs of the property and by an indication of its location. In the case of large projects, the lender will probably request an economic survey so that it may determine that a need actually exists for the construction being proposed. The lender will ask whether the property is free and clear. If it is not, the borrower must have some indication that the people holding the deed of trust on the property are willing to subordinate their first lien to the first lien that will be put on the property by the lender for their construction loan. There also must be some indication of how the subordinated lien will be paid off. The lender particularly desires to know whether the borrower plans to pay off the subordinated lien on the property from the proceeds of the loan at some stage during the construction of the building. Subordination agreements were very popular during the late 1950's and early 1960's. However, since then the subordination agreement has fallen into disrepute and is not being used as extensively as before. The decline in its popularity is due to the numerous cases in which it has been necessary for the seller of the property under the first deed of trust, later subordinated, to take back the property that he previously sold. In these instances he often found that there was a building under construction that needed several thousand dollars' more work before it would be completed, that street bonds had been placed on the property, and that to take back his property he had to assume the construction deed of trust, pay off the street bonds, and then complete the building. Should the building have been completed, it would still be necessary for him to assume the deed of trust to which his own deed of trust had been subordinated. In many instances it was financially impossible for the seller to take back his property under these circumstances. As a result of such occurrences, the subordination agreement received a great deal of bad publicity.

In some areas with no sewage facilities, counties require that before a building permit will be issued, a test hole be dug to determine whether adequate sewage disposal is available through a septic tank and leaching field or a septic tank and deep well system. In cases such as this, the lender would naturally want to see the results of the test to make sure that the loan it is proposing to make to the builder will be used to construct a building that will be occupied after it has been completed.

LOAN

After the application has been received, the next step is PROCESSING the appraisal of the project. In connection with the appraisal, the site must be analyzed to make sure that it complies with all local regulations. Some communities, for example, require that a lot contain 10,000 square feet for a single family home to be built on it. Lots have been submitted measuring 100 feet by 100 feet, which appear to conform with this regulation; however, upon investigation it has been found that the lot measures to the center of a road 40 feet wide, making the usable lot area only 80 feet by 100 feet (8,000 square feet), and therefore disqualifying the lot under the local ordinance. Therefore, it is important to be sure that the lot does comply with local regulations before the lender proceeds much further with a loan.

The lender is next interested in the off-site improvements. In some instances in which there are no sidewalks, curbs, or gutters, a recorded provision states that the owner of the property shall, under county requirement, install curbs and gutters at his own cost. Should the owner fail to install the curbs and gutters, the county has the authority to install the curbs and gutters by itself and to bill the property owner for the expense incurred. If the road is only graveled, a problem arises in connection with its maintenance and with possible future macadamizing of it.

The lender is interested in the feasibility of the project and in whether there will be a demand for the type of property that the completed project will provide. The lender will therefore appraise the plans and specifications on a cost of construction basis. While he is doing this he will also analyze the practicality of the plans, taking into consideration and the location of the rooms, the size of the rooms, and the presence of absence of built-in features. If there is a large discrepancy in the cost of the improvements, whether an overcharge or and undercharge, the lending officer might require the builder to come in and justify the contract that has been submitted. In their discussions they may make comparisons of similar units and their costs. If a discrepancy still exists, the lender might ask to examine the subcontracts to see whether some error has been made in their preparation. If the cost is too low, the lender realizes the possibility of the contractor's going bankrupt before the building is completed; if the cost is too high, he wants to see that there is justification for the extra charge.

If the loan is to be interim financing and no take-out commitment has been issued, the lender will probably request that the final lender be provided with the documents necessary to their making a fair analysis and determining whether a take-out loan will be available; otherwise they sometimes find it necessary to lower their standards to help a builder dispose of a subdivision or building that does not sell quickly.

ANALYSIS OF THE CONTRACTOR

In some instances the builder may be the contractor, but in all instances the lender is interested in the contractor who is doing the construction of the building. In his analysis of the contractor the lender realizes that several methods of operation are possible for a contractor. He may be operating as a corporation, in which case the liability of the contractor is limited to the assets of the corporation. He may be operating as an individual or as a partnership, in which case liability extends to both the assets of the business and the assets of each partner.

In conducting an investigation of a contractor whom he does not know, the lender will service a list of previous projects upon which this contractor has worked. The lender will investigate enough of these projects to determine what type of builder the contractor is. The inspection of these properties will reveal the type of finished work he produces, and a few questions will reveal the reputation of the contractor for that particular project. If he is a good contractor there will be no complaints; however, if the contractor has not done a satisfactory job, many complaints can be brought to light by questioning the occupants of the contractor's previously completed projects.

Trade journals will often reveal both favorable and unfavorable information concerning the contractor. Organizations such as the Builders' Exchange can supply information concerning various contractors in the area, as can the local chapter of the National Association of Home Builders. Sure sources of information as to the payment practices and the dependability of the contractor are his subcontractors and suppliers. As a rule these people will also be able to tell the lender the reputation that he has as a contractor. The subcontractors and suppliers often work through collection agencies such as the Retail Credit Association in cases of difficult collections and in cases in which it has become necessary to file liens against the property. The Retail Credit Association will usually have information concerning these liens; therefore, another source available to the lender for investigation of the contractor is the various credit agencies.

Whether or not the lender is satisfied with the information that is has developed concerning the contractor, it will usually require a financial statement. This financial statement will be analyzed as to whether the amount of working capital that is available to the contractor is sufficient to pay the bills and accounts payable that are shown. The contractor's net worth will be computed to see that there is sufficient worth available to meet any contingency that might occur in connection with the proposed project.

DISBURSEMENT OF CONSTRUCTION LOAN

There are three usual methods of disbursement for construction loans. First is the voucher system, a method in which the contractor is reimbursed for receipted bills. Reimbursement is made upon presentation of the bills to the lender. With this method it is important for the lender to verify that the material and labor have been used on the job covered by the loan being disbursed.

The second system is the warrant system, under which the bills, as they occur, are presented to the lender and are in turn paid by the lender directly to the supplier of material or labor. Once again, it is important that the lender makes sure that the bills being paid are for the project covered under the construction loan.

The third system of disbursement of the construction loan is by the fixed disbursement schedule. Under this program the lender, the builder, and the contractor agree on the number of payments that will be made during the construction of the property and on the stages at which these payments will be made. The number of payments varies from three to six. The most popular schedule, probably because more FHA loans are made than others, is the schedule established for the payment of construction loans under FHA inspection and construction. This program provides for three inspections, and after satisfactory completion of each of these three stages the contractor is entitled to payment. The fourth payment is made after the notice of completion is filed and the lien rights period has expired.

Another popular schedule calls for five payments. The schedule usually calls for one-fifth of the contract price to be paid when the foundation is in and has been back-filled; some schedules call for the subflooring to be on also. One-fifth is paid when the framing is completed and the roof is on; one-fifth when it is enclosed and ready for painting; one-fifth when the notice of completion is filed; and the final one-fifth after the lien right period has expired.

INTERIM LOAN UNDERWRITING

This section will deal with four basic types of financing:

1. Land Acquisition Loans.
2. Land Development Deals.
3. Construction Loans *Without* Permanent Commitments.
4. Construction Loans *With* Permanent Commitments.

These four basic types have several things in common:

1. Short-term, never to exceed 5 years.
2. No amortization (interest only).
3. High risk, therefore high interest rates.
4. Always require strong credit and personal guarantees.
5. Interest rates typically are tied to and float with the prime rate which can be adjusted daily.

Despite all of the common characteristics, these loan types differ dramatically in how they are structured. The following chart briefly summarizes the basic characteristics:

Loan Type	**Land Acquisition Loan (Zoned Land)**	**Land Development Loan**	**Construction Loan *Without* Permanent**	**Construction Loan *With* Permanent**
Risk Rating	Highest	Very High	High	Above Average
Typical Loan-To Value Ratio	50%	60-70%	70-75%	75-80% (never more than amount of takeout. If construction costs greater than permanent loan may get "gap" loan for difference)
Term	2-4 years	1-3 years	1-2 years	1-2 years (never longer period than take-out effective period)
Typical Interest Rate	Prime Rate + 3-6%	Prime Rate 3-5%	Prime Rate 3-4%	Prime Rate 2-3%
Releases	120-130% of Loan/Acre	115-125% of Loan/Acre	110-120% Loan/Unit	100% on Completion of Construction on Funding of Permanent
Basis of Value	Acquisition Price	M.A.I. Appraisal of Fully Improved Value	M.A.I. Appraisal of Resale Value	M.A.I. Appraisal Value Based Primarily on Economic Value

*To perform the acts of submission which include platting engineering, soils testing, curbs, sidewalks, utility installation and carrying costs. Rule of Thumb is: Expected sales price of "developed" land should include 1/3 Profit, 1/3 Land Cost (Raw) and 1/3 Development Costs.

LAND DEVELOPMENT LOANS
The only reason for a land development loan is to pay the improvement costs of a project which will take several years to complete, for example, a subdivision, townhouse complex, or large industrial park. Note the crucial difference between a development loan and an acquisition loan.

THE SPECIFIC USE HAS NOW BEEN DETERMINED
Zoning alone does not determine specific use. The land, at this stage, has been planned with utility and street layouts and a preliminary plat has usually been prepared.

Lenders will typically provide all of the dollars necessary to acquire the land, put in all of the improvements and pay the carrying costs for the term of the loan. These loans will average 2/3 of *value on completion* of the developed subdivision without any buildings constructed on it (*e.g.* what the "ready-to-build" lots would sell for). In most cases the land costs will be 1/3 of final value and the improvement and carrying costs will be 1/3 of final value. This leaves 1/3 of value as profit.

If the cost figures supplied by the developer vary by more than 10% from these ratios - watch out! This is a good indication that something is wrong. May be the developer is over-paying for the land or his estimated improvement costs are off. In any event, be alerted to the fact that something is wrong. Unless there is at least 30% profit, chances are the deal is not worth doing. If the lender will make a loan where there is less than a 30% margin, the difference will have to be supplied in equity funds by the developer (*e.g.* more payment of costs, up front, by the borrower).

Typically, the lender will insist on a covenant to do all of the eventual construction financing at the prevailing market rates. Releases are obtained by repaying the development loan at something between 115% and 125% of the loan per acre. The funds would generally come from the construction loan which is made under another set of terms and conditions. The intent of the release clause is to get the development lender out of the deal early. By accelerating the repayment, the lender has been fully paid back when approximately 80% of the land has been used. It also serves to keep the developer's profit in the last 20% of the land, *i.e.* dollars received on the first 80% of the land sold or refinanced are used to retire the debt.

EXHIBITS REQUIRED

1. Developer's financial statements, credit reports and D&B's.
2. Resume of construction experience of developer.
3. Site information:

(a) Survey and Legal Description.
(b) Site Plan showing streets and utilities, either preliminary or final.
(c) City Map showing project location and other significant developments nearby.
(d) Aerial photographs.

4. Cost estimates of the improvements to be made, including interest cost and fees.
5. M.A.I. appraisal of completed value.
6. Project timetable showing start of development, phasing, total estimated time to complete and protect usage pattern.
7. Cash Flow projection of dollars to be paid out and dollars to be received and when.

CONSTRUCTION LOANS WITHOUT PERMANENT COMMITMENT

The most common use for this type of financing is the condominium or for-sale townhouse project being built without presales. Quite obviously, since the ultimate owners of the units are not known, there can be no real permanent commitment. In the case of condominiums and townhouses most construction lenders require a "take-out" commitment being available. This is an agreement by an end lender to provide the "home loan" to the ultimate borrower, typically at then current rates and terms.

Taking the place of a permanent mortgage commitment in the case of other projects which typically have permanent loans (office, shopping center, *etc*.) is a "standby commitment." A standby is necessary because, by law, no commercial bank can make a construction loan without a commitment from somewhere to take it out on completion. A standby is a commitment made, usually by the construction lender itself to pay off its own construction loan at completion with a *very short term* "permanent" mortgage. This "permanent" mortgage is non-amortizing, usually for a term of one year longer than the estimated construction period, and at some ridiculously high rate of interest. Quite obviously, they are never intended to be funded. They are primarily a device to enable commercial banks to do this type of construction financing.

The combination of a construction loan and a standby commitment is sometimes referred to as "bridge financing," *i.e.* it bridges the gap between the start of construction and the sale to and financing of the ultimate buyer. Although R.E.I.T.'s technically don't need standby loans to make the construction loan the cost of their funds is higher than that of commercial banks and they need the extra fees to make a big enough profit to justify the risk.

Bridge financing is usually available in an amount up to 70% of M.A.I. appraised resale value of the complete building. The loan amount should be sufficient to pay off the underlying development loan, if one exists, or to pay all acquisition and improvement costs if it is a one phase project. In addition, it should cover all construction costs, marketing costs, and carrying costs. In other words, this type of loan will pay for almost everything but sales commissions and developer profit. As with the development loan, repayment is accelerated by using a release clause which requires from 110-120% of the loan per unit to be repaid in order to clear the individual unit for permanent financing in the case of condominiums or townhouses.

In the case of the other projects, the loan is paid in full from the proceeds of the permanent loan ultimately obtained, typically after completion and leasing of the project. Once again, as with the development loan, any funds required from the lender is excess of 70% of value should be a danger signal and if the lender is willing to make the loan at all, it will be with the funds required in excess of 70% considered front-end equity and escrowed for payment of bills beyond the loan amount.

While this kind of financing is still very risky, it is safer than acquisition and development financing. The only reason it is safer is that the project is being brought closer to mass marketability. In other words, the lender's risk of losing his mortgage investment is being reduced. Nonetheless, the risk is still very high in the spectrum of real estate finance. Not until the project is completed does the risk go down another notch, and not until the project's salability has been demonstrated does the lender begin to breathe easier. We want to strongly emphasize that building and selling condos is not for amateurs. Not only does the job require the normal construction expertise, but it requires that the developer have available a top-notch marketing capability. Lenders will usually require strong financial statements and personal guarantees for a construction loan without permanent, particularly on a "for-sale" condo or townhouse.

Always keep in mind that you are usually building and financing a "spec" subdivision - nothing more and nothing less! The best guide is common sense in your approach to feasibility: Do the unit designs make sense with regard to room sizes and traffic patterns? Are the units priced right for the area? How is the access? Are there shopping facilities nearby? Most of all, who is the potential buyer or lessee and does the unit fit their needs?

You should learn their market. If it is a "for-sale" condo or townhouse, tell the client to take out their spouse and look at the competition. Pick up sales brochures; ask about square footages and prices. Figure out what the project sells for per square foot. What amenities are included? Which features are standard and which are optional? All of this information is necessary before you can properly apply common sense. Local sales or rental brokers are a vital source of good "prediction" and present day information.

EXHIBITS REQUIRED

1. Developer's financial statements, credit reports and D&B's.
2. Resume of construction experience and *marketing* experience of developer.
3. Site information:
   (a) Survey and Legal Description.
   (b) Site Plan financially approved.

(c) City May showing project location and other significant developments nearby.
(d) Aerial photographs.

4. Approved plans and specs.
5. Construction cost statement.
6. M.A.I. appraisal of resale value.
7. Project timetable showing start of date, phasing, estimated construction time, and sales projections.
8. Homeowner's Association Documents.
9. Resume on Manager and Leasing Sales Agent for the project.

CONSTRUCTION LOANS WITH PERMANENT COMMITMENT

Only a few permanent lenders also provide construction loans. The exception to this general rule is the California Savings and Loans who emphasize single family and multi-family (apartment and condo) loans and are usually less competitive in their financing of non-residential projects. This is because until recently Savings and Loan regulations require them to loan approximately 90% of their funds on residential properties. Many Savings and Loans will not provide construction loans. Therefore, once a permanent loan commitment has been obtained by a developer for an apartment complex, office building, *etc.*, he then takes this commitment along with his entire permanent loan submission to his commercial bank to secure a construction loan.

The construction lender is concerned first with the validity of the permanent commitment and then with the developer's cost estimates and his ability to perform. At all times there must be sufficient funds available to complete the project. The permanent loan will not become effective until such time as the project is completed substantially according to plans and specs. In other words, the construction loan will never exceed the amount of the permanent commitment and if the estimated costs are greater, the developer will have to put in equity dollars *front-end* to keep the construction loan in balance.

Most Mortgage Bankers do not provide construction loans themselves, although many did so in the past. Therefore, the Mortgage Banker's involvement relates only to its ability to help the developer negotiate his construction loan. The Mortgage Banker, or others, can assist the developer in reducing its money costs by supplying the construction lender with non-interest bearing compensating balances. This reduces the Bank's cost of funds which can then be passed on to the developer. Some Banks will require both compensating balances and establishment of account relationships in order for them to provide construction financing. Frankly, although establishing account relationships may not be required, it is usually extremely helpful.

EXHIBITS REQUIRED Same as for "Construction Loan Without Permanent" except add the Permanent Loan Commitment and Financial Information on the Permanent Lender, when necessary.

THE INTERMEDIATE TERM LOAN OR "MINI-PERM"

The concept is a loan (sometimes referred to as a "mini-perm") whose term is from one to ten years, with long-term amortization schedules similar to permanent mortgages, with liberal prepayment privileges and rates usually within 1/2% of the long-term market rate for comparable properties. This gives the developer a firm permanent loan, so the construction lender is assured that the building loan will be repaid upon completing of the property. Therefore, the construction loan rates and underwriting patterns will be those of a Construction Loan with a Permanent.

Developers often use a mini-perm or this type of intermediate-term loan as a "fundable standby" to secure a construction loan without first going through the often protracted application for a long-term loan. In addition, the developer may wish to begin construction immediately to take advantage of a favorable labor market or avoid unfavorable seasonal building conditions. The developer may also be concerned about the interest rates then current on long-term funds, or capitalization rates, and may wish to shop for his permanent loan in a more favorable money market.

Most Long Term (Permanent) Loans contain heavy penalties for paying off the loan prior to maturity. Some do not allow any "pre-payment" during the first ten loan years. The intermediate term loan is slightly higher in interest rate but allows "pre-payment" at any time. This encourages the developer to refinance with an advantageous permanent loan at the right time. In addition an existing and proven project usually commands more attractive long-term financing than a proposed project. By using an intermediate-term loan until the project is completed and leased, the location is established and the grass, trees, and bushes are in place, the developer can seek a permanent loan with the location and aesthetics proven.

Perhaps the most commonly thought-of external condition favoring refinancing is the inflationary spiral. It seems to be an economic fact of life that income properties can be expected to produce higher rent rolls year after year, and this would suggest higher loan amounts. However, increasing operating expenses, higher interest rates and real physical depreciation of the property, may offset increased rentals and neutralize the benefits of intermediate-term financing for the developer who wants to build at today's costs and finance at tomorrow's rents.

A more subtle implication of the economic climate relates to the phenomenon of peaks and valleys or rental demand. Permanent lenders often react simultaneously to a strong or weak rental market. When there are few or no vacancies in a given locality, lenders easily fund new developments. Unfortunately, this enthusiasm sometimes creates an oversupply, and demand is exceeded. Then, because of the over building, lenders will not resume financing until most of the vacancies are absorbed.

However, because of the substantial time lag between financing a building and its availability for rental, the sophisticated developer may wish to begin construction even when a glut of space is still on the market if he is confident that the excess supply will have been absorbed by the completion of construction. If that is correct, use of the intermediate-term loan would allow the developer to time permanent refinancing to the long-term lenders' return to the market.

The typical intermediate-term loan has a 25 year amortization schedule but must be repaid by the end of the 3rd, 4th, or 5th year. However, some offer only 10 to 15 year terms. The loan-to-value ratio and other terms are similar to permanent loans, except the interest rate is 1/2% to 1% higher than those on Permanent loans available at the time of application for the intermediate-term loan. There are usually no "pre-payment penalties" or "lock-in" periods.

CHAPTER FIVE

REAL ESTATE FINANCING AND FUNDAMENTALS OF INVESTING

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Learning Objectives:

After studying this chapter you will be able to:

1. Outline the loan process.
2. Describe an online loan application.
3. Explain and give examples of the lending laws.
4. Identify sources of funds.
5. Summarize the classification of mortgages.
6. State the type of financial paperwork needed.
7. Document the follow up of the loan process.
8. Explain how to get started as an investor.
9. Describe the factors to be considered in investment decisions.
10. Define return and risk.
11. Discuss the risk-return tradeoff.
12. List the types of risk.
13. Identify the factors to be considered in housing decisions.
14. State how to invest in real estate.

REAL ESTATE FINANCING

This section deals with two major aspects of real estate financing: (1) financial instruments and (2) the means of financing. It examines the financial side of the lending process. The typical steps in the loan process are explained and pertinent lending laws are described. Both primary and secondary sources of funds are identified. Common types of loans are classified, and some innovative financing techniques are examined.

THE LOAN PROCESS

Financial intermediaries providing the funds for development and purchase of real estate have traditionally taken a conservative approach towards the amounts they lend and the requirements the borrower must meet before securing the loan. This is no doubt partly due to the fact that the largest providers of credit are highly regulated by both federal and state agencies. Consequently, the loan process followed normally involves a number of steps, explained in the discussion that follows.

QUALIFYING THE BORROWER

The loan process begins when a potential borrower approaches either the lender or a representative of the lender with the intention of securing a certain amount of money. Historically, loan-to-value ratios were much lower than they are today and subsequently in case of default the lender was in low risk position. However, as loan-to-value ratios have increased, it has become necessary for the lender to look beyond the property and thus qualify both the credit and the financial ability of the borrower to repay the loan. This involves the filling out of a loan application which asks for employment, credit history, assets, liabilities and other personal information. Once this information is obtained the lender then verifies it. When it is verified, the lender can make a credit evaluation that becomes an important input into the final loan decision.

QUALIFYING THE PROPERTY

Lenders are not in business to foreclose on property; rather, they are in business to lend money, charge interest on that money and hopefully receive payment of both interest and principal. However, under certain condition, both within and beyond the control of the borrower, the lender may find it necessary to foreclose on the property used to secure the debt.

Factors such as location, age, condition, surrounding land uses and general economic conditions all have an effect on the value of a piece of real estate. For most mortgages the amount of money loaned will be based on either the contract sales price or the appraised value, whichever is less. Therefore, before making the loan decision the value of the property must be estimated by the lender or someone employed to do so.

QUALIFYING THE TITLE

So as to determine the lien position of a mortgage given on a piece of property, the lender seeks to qualify the title by examining the public records and tracing the legal history of the property. The lender normally desires a first lien position which can be determined by an abstract of title. Also, since the lien is on a piece of property, the lender wants to be assured that the property being offered as collateral is the same piece being purchased; thus a property survey will also be conducted prior to closing the loan transaction.

CLOSING THE LOAN TRANSACTION

Once the buyer and the property have been qualified and after the lender is confident that title to the subject property is free and clear, the final step in the loan process involves closing the loan transaction. Depending on where one resides in the United States, the title closing process is referred to as a *closing, settlement,* or *escrow*. In California title closing is conducted by an escrow agent who is a neutral third party mutually selected by the buyer and seller to carry out the closing.

ONLINE LOAN APPLICATION

Many lenders (such as www.lendingtree.com, www.eloan.com, wwwditech.com, and the like) have online loan processing system in place. Typical online loan application involve the following steps:

- **Apply:** Complete an online loan application. Before starting the online loan application you will need to create an account, to protect your privacy and security of your information.
- **Review:** A loan officer will review your application. The lender will notify you of their decision by phone and/or mail. Your loan agent will contact you within 24 hours to confirm information and discuss your loan application.
- **Sign:** The lender will assign a processor to your loan and set up a signing appointment.
- **Fund:** Once they approve your application, you sign the loan documents and you satisfy all closing conditions, they will disburse your loan proceeds, usually within 7-10 days.

LENDING LAWS

Certain lending laws are applicable to all lenders providing real estate financing. Since the purpose of such laws is to provide protection for the borrower, the limitations and requirements imposed through these laws must be strictly adhered to. Among the pertinent lending laws are the following. Federal Reserve Board regulates the loan policies of national banks.

USURY

A number of states have laws which limit the interest rate that can be charged to individuals borrowing money in that state. These laws affect all lenders in a state regardless of what federal or state agency issued their charter. It should be noted that, if there is a national economic emergency, the federal government may temporarily suspend state usury laws.

California's usury law limits the interest rate on nonexempt real estate loans to the discount rate charged by the Federal Reserve Bank of San Francisco plus 5%. The California Constitution states that the following kinds of loans are exempt from state usury laws: (1) loans made by banks, savings and loans, and credit unions; (2) loans made by personal finance companies and pawnbrokers; (3) loans made or arranged by real estate brokers.

Therefore, as a practical matter, the state's usury laws now apply only to private lenders.

TRUTH-IN-LENDING LAW (REGULATION Z)

The National Consumer Credit Protection Act, referred to as the Truth-in-lending Act, became effective July 1,1969. Regulation Z, published by the Federal Reserve System to implement this law, requires lenders to make meaningful credit disclosures to individual borrowers for certain types of consumer loans. The regulation also applies to all advertising seeking to promote credit. This advertising is required to include specific credit information. Consumers are given information on credit costs both in total dollar amounts and in percentage terms. The intent of Congress was to assist consumers (residential, noninvestment customers) with their credit decisions by providing them with specific required disclosure and does not attempt to establish minimum or maximum interest rates or other charges.

TO WHOM DOES REGULATION Z APPLY?

Regulation Z applies to a person (or business) who is classified as a "creditor". A creditor is one who regularly extends consumer credit that is either subject to a finance charge or is payable in more than four installments. The phrase "regularly extends" means that a person or firm has been engaged in five or more transactions in the past calendar year. Regulation Z also requires that the note signed by the consumer be payable on its face to the creditor. In other words, Regulation Z applies only to actual extenders, real estate broker or salesperson who helps arrange creative financing to sell a house, the broker salesperson would not have to comply with Regulation Z disclosure requirements.

WHAT TRANSACTIONS ARE COVERED?

All real estate lending transactions involving consumers are covered by Regulation Z. Except for real estate transactions, all credit extended in five or more installments and not in excess of $25,000 for personal, family, household or agricultural purposes is covered by the regulation. The regulation does not apply to credit extended to nonnatural persons such as corporations or governments, to credit extended for business and commercial purposes or for credit transactions with an SEC-registered broker for trading in securities and commodities. The regulation applies to new loans, refinancing or consolidation of loans. However, an assumption of a loan by a new borrower is exempt.

Notice that Regulation Z applies to consumer real estate transactions. Would a loan to renovate an apartment building be covered by the regulation? Since an apartment building is normally a business to collect rents from tenants, this would not be deemed a consumer transaction. Thus, the loan would be exempt from Regulation Z reporting requirements.

WHAT INFORMATION MUST BE DISCLOSED?

The law requires a lender to make several types of credit information disclosures. Two important disclosures include the finance charge and the annual percentage rate (APR). The finance charge includes a disclosure of the following: interest, finder and origination fees, discount points, service charges, credit report fees and other charges paid by the consumer directly or indirectly which are imposed as an incident to the extension of credit. Certain fees which are not in fact additional finance charges are exempt. These charges may include various title examination fees, escrow requirements and appraisal fees. To determine the charges which are covered or exempt, Regulation Z should be examined by anyone extending credit to consumers. (Note: this includes brokers, professionals and craftsmen as will as financial intermediaries, unless exempt.) The APR is the yearly cost of credit stated to the nearest one-eighth of 1 percentage point in regular transactions and the nearest one-fourth of 1 percentage point in irregular transactions. A transaction is irregular if repayment is in uneven amounts or the loan is made in multiple advances. The APR is usually different from the contract or nominal rate of interest and includes the impact on the effective rate from discount points and other charges. The calculation of the APR is complex and involves the use of actuarial tables which are available from the Federal Reserve and member banks.

EXAMPLE

Tom borrows $1,000 from Holly which is repayable in one payment at the end of the year. The loan is to finance a real estate purchase. They agree to a contract rate of 10% plus four discount points. What is the APR?

Actual amount borrowed:
1,000 - $40 [discount points] = $960
Amount to be paid back:
$1,000 + $100 [contract interest] = $1,100
Actual interest: $1,100 - $960 = $140
APR: $140 / $960 = 14.58%

This calculation would differ depending on the term of the loan and the amortization period. If the interest is collected in the beginning, the APR could be twice the contract rate. If the loan involves variable payments, then the creditor must disclose how the payments may change, including the index that is being used, limitations on increases and an example illustrating how payments would change in a given increase. In addition to the finance charge and the APR, anyone extending credit must also disclose such information as the number, amount and time that the installments are due, description of the penalties and charges for prepayment and the description of the security which is used as collateral, as in refinancing or using a second mortgage to obtain equity. The consumer has three business days to rescind (cancel) the credit transaction. This right of rescission does not apply to credit which was used to purchase the home originally.

EFFECT OF VIOLATIONS

Violation of Regulation Z provisions can lead to both civil and criminal penalties. Civil penalties include a penalty of up to $1,000 paid to the borrower, actual damages plus attorney's fees. Criminal penalties include a fine of up to $5,000, up to one year in jail, or both.

EQUAL CREDIT OPPORTUNITY ACT

As originally passed, the Equal Credit Opportunity Act prohibits discrimination by lenders on the basis of sex or marital status in any aspect of a credit transaction. As of 1977, the act was extended to cover additional protected groups of borrowers. These include individuals who are discriminated against on basis of race, color, religion, national origin, age, receipt of income from a public assistance program and good faith exercise of rights under the Consumer Protection Act. Exceptions to the protection of the law are individuals who do not have contractual capacity (minors) and individuals who are noncitizen and whose status might affect a creditor's rights and remedies in the case of a default.

The purpose of this law and Regulation B, which was issued by the Board of Governors of the Federal Reserve System, was to assure that lenders would not treat one group of applicants more favorably than other groups except for reasonable and justifiable business reasons. Strict rules have been established to require fair dealing in all aspects of a credit transaction.

A creditor failing to comply with the law is subject to civil liability for damages in individual or class actions. These damages can be actual or punitive. Punitive damages are intended to punish a wrongdoer. These are limited to $10,000 in individual actions or the lesser of $500,000 or one percent of a creditor's net worth in class actions. A class action occurs when a specific group of individuals has been harmed from a violation of the law. In general, lawsuits must be filed within two years of a violation.

The law is very broadly worded and covers all phases of a credit transaction. The following is a lender's lists of " do's" and "don'ts":

1. Do not ask about a person's birth control practices or intentions to bear children; however, a neutral question such as whether the applicant expects his or her income to be interrupted in the future is considered proper.
2. Do tell the applicant that income from alimony or child support need not be disclosed unless the applicant wishes this source of income considered.
3. Do tell the applicant that the federal government needs certain information for monitoring purposes, but that this information will not be used as a means of discrimination. Note that the applicant may decline to furnish this information.
4. Do not require a spouse to co-sign a credit instrument except where state laws, such as California's community property law, require a signature to create a proper lien on property serving as security for a loan.
5. Do not use age in evaluating an applicant's creditworthiness. One exception to this rule is if the applicant is considered "elderly" (age 62 or over), and the age is being considered to favor the applicant.
6. Do not require the applicant to reveal marital status. This extends to the use of courtesy titles (Ms., Mr., Mrs., Miss) unless requested by the applicant.
7. Do furnish credit information in the names of both spouses for the purpose of establishing a credit history in each name if both are participating in the loan.
8. Do notify the applicant within 30 days whether you are approving the loan or taking an adverse action.
9. Do give a specific reason for an adverse action. Specific reasons could include: no credit file, insufficient credit references, law suits, liens, excessive obligations, delinquent credit obligations, unable to verify employment or income, denial by FHA or other government programs, inadequate collateral.
10. Do retain records for at least 25 months after notifying applicant of action taken.

FAIR CREDIT REPORTING ACT

This act, which became effective April,1971, attempts to regulate the action of credit bureaus that give out erroneous information regarding consumers. First, banks and credit companies must make a consumer's credit file available to the person in question. Further, the consumer upon examining the file, has the right to correct any error that may appear in the credit reports. Secondly, if a creditor denies a loan to an applicant, the applicant must be given the name and address of the credit bureau that supplied the credit information to the creditor. Upon request, the credit bureau must supply the consumer with the pertinent information contained in the applicant's credit file. Finally, the act limits the access of the consumer's credit records to people who: (1) evaluate an applicant for insurance, credit or employment; (2) secure the consumer's permission; or (3) secure court permission.

COMMUNITY REINVESTMENT ACT (CRA)

In order to prevent the practice of redlining and disinvestment in central city areas, Congress passed the Community Reinvestment Act. 'Redlining' is a practice whereby lenders refuse to make loans in certain geographic areas of a city. It is as if someone had taken a red pencil and drawn a line around the boundary of neighborhood and said that no loans would be made in that neighborhood.

To comply with the act, lenders must prepare Community Reinvestment Statements. These statements contain up to four basic elements:

1. The lender delineates a 'community' in which its lending activities take place. The lender may use political boundaries, to designate an 'effective lending territory' in which a ' substantial portion' of its loans are made, or any other 'reasonably delineated local area.' Care must be taken that such designations do not unreasonably exclude territory occupied by persons of low or moderate incomes (see also requirements in Federal Fair Housing Laws)
2. The lender must make available a listing of the types of credit it offers in each community.
3. Appropriate notice and information regarding lending activity by territory must be given or made available for public inspection. The specific language of the notice is dictated by the government.
4. The lender has the option to disclose affirmative programs designed to meet the credit needs of the community.

NATIONAL FLOOD INSURANCE

In 1968, Congress enacted the National Flood Insurance Program. The intent of this legislation is to provide insurance coverage for those people suffering both real and personal property losses as a result of floods. To encourage the buying of national flood insurance, any real property located in a flood plain area cannot be financed through a federally regulated lender unless flood insurance is purchased.

SOURCES OF FUNDS

Since such a small percentage of the purchase price of real estate is normally provided from the savings of the purchaser, available sources of funds need to be known to anyone desiring to purchase real estate. For purposes of discussion, the more common financial sources have been divided into four groups: (1) primary sources, (2) financial middlemen, (3) other sources and (4) the secondary mortgage market.

PRIMARY SOURCES

SAVINGS AND LOAN ASSOCIATIONS

While savings and loan associations (S&Ls) are not the largest financial intermediary in terms of total assets, they are the most important source of funds in terms of dollars made available for financing real estate. S&Ls have sustained large asset growth in recent years, and currently the total assets of the 3,900 associations is second only to commercial banks. Traditionally, they have been the largest supplier of single-family owner-occupied residential permanent financing, although S&Ls are not limited solely to this type of financing. Savings and loan associations also make home-improvement loans and loans to investors for apartments, industrial property and commercial real estate. Recently, primarily as a result of the restructuring of lending activities through deregulation, the average S&Ls assets invested in mortgages has continued to decrease. Savings and loan associations first began in the mid 1800s as building associations.

An S&L is either federally or state chartered. Approximately 40% of the S&Ls are federally chartered. If federal, the association must be a member of the Federal Home Loan Bank System (FHLBS), and its funds must be insured by the Federal Savings and Loan Insurance Corporation (FSLIC). All federally chartered S&Ls are mutually owned (owned by depositors) and the word 'federal' must appear in their title. State chartered S&Ls can be either mutually owned or stock associations. (In a stock association, individuals buy stock which provides the equity capital.) They have optional membership in both the FHLBS and the FSLIC. In some states, these lenders are known as building and loan associations or cooperative banks.

While lending policies vary from association to association, most S&Ls are involved in the same type of activities and with the same basic lending requirements. The following are common lending policies:

1. The bulk of their mortgages are in conventional loans for single-family residential real estate.
2. Most S&Ls provide both FHA and VA financing, although these loans typically comprise a small percentage of total assets.

3. The majority of loans are made locally. Funds are typically not available to faraway geographic areas. However, recently some of the larger associations have been engaged in lending funds to users in other states through service corporations and correspondent accounts.
4. Residential loans are usually for 25- or 30-year periods calling for periodic (monthly) full amortization. The current average maturity for conventional mortgages on new homes is approximately 28 years.
5. While conventional loans can be made for up to 95% of a property's value, the average loan-to-price ratio on new conventional mortgages on new homes is between 75 and 80%.
6. Any S&L handling VA mortgages is subject to interest rate ceilings set by the federal government, regardless of who issued the association's charter.
7. All S&Ls are expanding the type of services they offer in terms of more consumer loans, checking accounts and services, heretofore, limited to commercial banks.

COMMERCIAL BANKS

In terms of total assets, the more than 14,500 commercial banks are the largest financial intermediaries directly involved in the financing of real estate. Commercial banks act as lenders for a multitude of loans. While they occasionally provide financing for permanent residential purchases, commercial banks' primary real estate activity involves short-term loans, particularly construction loans (typically six months to three years) and to a lesser extent home-improvement loans. Most large commercial banks have a real estate loan department; their involvement in real estate is through this department. Some of the largest commercial banks are also directly involved in real estate financing through their trust departments, mortgage banking operations and real estate investment trusts.

All commercial banks are either federally (nationally) chartered or state chartered. National banks are chartered and supervised by the U.S. Comptroller of the Currency. The word 'national' appears in their title, and they are members of the Federal Reserve System (FRS). However, only one-third of all commercial banks are members of the FRS, even though the member banks control the majority of total bank assets. Nationally chartered banks are also required to maintain membership in the Federal Deposit Insurance Corporation (FDIC). Federally chartered banks can make real estate residential loans up to 90% of the appraised value with a maturity of not more than 30 years. However, any government insured or guaranteed loans are exempt from these limitations.

State chartered banks are regulated by various agencies in their particular state, and membership in both the FDIC and the FRS is optional. Banks not members of the FDIC are normally required to maintain membership in a state insurance corporation.

LIFE INSURANCE COMPANIES

Insurance companies play an important role as providers of capital for real estate from an equity (owner) standpoint. Unlike the savings and loan association or the bank, which normally deals directly with the borrower, the 1,800 insurance companies typically do their lending through local correspondents, either mortgage brokers or mortgage bankers. Insurance companies normally specialize in large-scale projects and mortgage packages. Historically, between 25 and 30% of their assets have been invested in mortgages.

Insurance companies receive their money through the payment of premiums by their policyholders and since both the inflow of premiums and the outflow of claim payments can be predicted with reasonable accuracy, insurance companies are able to invest in those assets yielding higher returns but less liquidity than is available to either banks or associations. For their real estate investments, this normally means long-term commercial and industrial financing. While insurance companies have historically invested in residential mortgages, this form of investment has continued to become a smaller and smaller percentage of their portfolio. Few insurance companies presently originate residential mortgages.

All insurance companies are state chartered since there is no federal agency which issues charters. The result is less regulation in most states than is true for either S&Ls or banks. Less regulation generally results in liberal lending patterns which leads to the funding of a wide variety of real estate projects. Over 90% of the insurance companies are stock companies; however, the majority of the industry's assets are held by mutual companies.

MUTUAL SAVINGS BANKS

Located primarily in northeastern states, the 500 mutual savings banks are an important supplier of real estate financing. As their name indicates, these banks are owned by their depositors. who receive interest on their deposits.

All mutual savings banks are state chartered and typically are less regulated than their closest financing relative, the savings and loan association. The percentage of their assets invested in real estate mortgages is less than the average S&L, although a higher percentage of their total mortgage portfolio is FHA and VA loans. Most mutual banks have a relatively larger percentage of their mortgage. Mutual banks also make personal loans which can result in capital being moved from surplus areas to deficit areas. Over two-third of the mutual banks maintain membership in the FDIC. The remaining ones are insured by state savings insurance agencies. These state agencies exercise authority over both the type of investments and the amount of their assets mutual banks can invest in particular types of real estate.

FINANCIAL MIDDLEMEN

MORTGAGE BROKERS

Mortgage brokers are not direct or primary suppliers of capital. However, they do play an important and necessary role in the financing process. A mortgage broker is a person who serves to bring together the user of capital (borrower or mortgagee). For this service, a finder's fee equal to one percent or so of the amount borrowed is normally paid by the borrower. The financial success of the mortgage brokerage firm depends upon the ability to locate available funds and to match these funds with creditworthy borrowers.

Certain sources of funds, particularly insurance companies and the secondary sources discussed below, do not always deal directly with the person looking for capital; rather, they work through a mortgage broker. Thus, if you wish to borrow from certain lenders you would need to go through a mortgage broker. Normally, the mortgage broker is not involved in servicing the loan once it is made and the transaction is closed.

MORTGAGE BANKERS

The mortgage banker is also a financial middleman; however, the services offered include more than simply bringing borrowers and investors together. Mortgage bankers normally make mortgage loans, package these loans and then sell these packages to both primary loans and secondary investors. Financial help is often sought from a lender, typically a commercial bank.

The bank becomes a warehouse for mortgage money, and the mortgage banker draws for mortgage money, and the mortgage banker draws on these funds until payment is received from the investors. Usually the mortgage banker continues to service the loan (collect debt service, pay property taxes, handle delinquent accounts, etc.) even after the loan has been packaged and sold. For this management service a small percentage of the amount collected is retained before forwarding the balance to the investor. Obviously, the success of the mortgage banker depends upon the ability to generate new loans. In some geographic areas, mortgage bankers are the primary source for financing real estate. All mortgage bankers try to stay in constant touch with investors and are aware of changing market conditions and lender requirements. Quite often the loan origination fee or finder's fee charged the borrower is more than offset by a lower interest rate from a lender not directly accessible to the borrower. Mortgage bankers are involved in both commercial and residential financing and also carry out related activities such as writing hazard insurance policies, appraising and investment counseling. As with mortgage brokers, mortgage bankers are regulated by state law.

OTHER SOURCES

Besides the four primary sources of funds, a number of other sources are available and each plays an important role in financing real estate. Most of these sources rely on mortgage brokers and mortgage bankers to assemble loan packages for them since they normally do not provide funds directly to the ultimate user.

PENSION FUNDS

Pension funds are one of the newer sources available for financing real estate. Whereas these funds historically were invested in stocks and bonds, the recent growth of pension funds has meant new outlets had to be found for their investments. This growth, plus the favorable yield available through real estate investments, has resulted in active participation in financing real estate projects. Besides making mortgage loans, pension funds also own real estate. The majority of all their real estate activity is done through mortgage bankers and mortgage brokers.

FINANCE COMPANIES

Traditionally, finance companies have provided consumer loans for the purchase of both durable and nondurable goods. However, as commercial banks have become more and more involved in personal loans, finance companies have turned to other forms of investment including real estate mortgages. In residential real estate, finance companies are actively engaged in second mortgages. This type of mortgage is usually made at an interest rate four or more percentage points above the rate on first mortgages and is amortized over a much shorter time period. Some of the larger finance companies--such as those owned by the automobile manufacturers--finance land development, provide commercial gap financing, acquire land leaseback and enter into joint ventures with real estate developers.

REAL ESTATE INVESTMENT TRUSTS (REITS)

Federal legislation passed in 1961 created Real Estate Investment Trusts (REITs). REITs pool the money of many investors for the purchase of real estate, much as mutual funds do with stocks and bonds. There are three types of REITs. An equity trust invests their assets in acquiring ownership in real estate. Their income is mainly derived from rental on the property. A mortgage trust invests in acquiring short-term or long-term mortgages. Their income is derived from the interest they obtain from their investment portfolio. A combination trust combines the features of both the equity trust and the mortgage trust. Their income comes from rentals, interest, and loan placement fees. REIT shares trade on the major stock exchanges or over the counter. For more on REITs, visit National Association of Real Estate Investment Trusts (www.nareit.com/mynareit.cfm).

CREDIT UNIONS

While the majority of loans made by credit unions are consumer loans some of the more than 22,000 credit unions provide mortgage money for both residential and nonresidential financing. In addition to permanent loans, credit unions also make home-improvement loans directly to depositors. Credit unions normally use mortgage brokers to locate real estate investments for their portfolios.

INDIVIDUAL INVESTORS

There are a number of large investors located throughout the United States who constantly lend money on real estate. These investors include individuals with available funds, groups of investors seeking mortgage ownership and large investment companies desiring to hold a diversified portfolio. They deal both direct and through mortgage brokers. Additionally, many of these investors seek to take an equity position in real estate. It is thus possible to raise equity capital through syndication instead of relying solely on mortgage funds.

FOREIGN FUNDS

Over the past decade, a substantial sum of foreign capital has flowed into the United States and much of it has taken the form of real estate equity capital. The relatively high return offered through real estate ownership in this country coupled with a stable economic system means a financially attractive alternative for foreign investors.

FARMERS HOME ADMINISTRATION (FMHA)

The Farmers Home Administration is an agency of the U.S. Department of Agriculture. Currently, FmHA administers two loan programs for rural housing: (1) a direct loan program and (2) a guaranteed loan program. Properties securing such loans may not be located in urban areas and , like FHA and VA, FmHA requires that the property meet certain minimum requirements. Although there is no statutory loan limit for such loans, the property must appraise for the contract sales price. Information on both loan programs is available from any office of the Farmers Home Administration.

STATE FINANCE PROGRAMS

Numerous states have enacted home financing programs that provide direct loans at preferred interest rate to citizens of that state who, for various reasons, have been unable to obtain financing from private institutions. Applicants must be residents of the state for a specified period of time and under most programs may not own other real property. In recent years, cities and countries have also established mortgage funds in order to meet the needs of the housing market in their political jurisdictions.

THE SECONDARY MORTGAGE MARKET

The availability of funds for financing real estate is affected by economic conditions, both local and national. The result is that at certain times or in certain geographic locations little or no capital is available for mortgages; consequently, few if any loans are made. From the viewpoint of the lender, another problem is that real estate loans can be highly illiquid; thus, the supplier of funds can have a difficult time converting loans into cash. For these reasons, the need exists for some means by which a lender can sell a loan prior to its maturity date.

The secondary mortgage market attempts to meet these needs. Capital can be made available during times of tight money and at capital-deficit locations. By selling mortgages in the secondary mortgage market, a lender can convert existing mortgages into cash which can in turn be used to fund new mortgages. Likewise, an investor in the secondary market can buy existing mortgages, pay the seller a small servicing fee and avoid the time and expense of originating and servicing the loans.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FANNIE MAE)

The largest and best known buyer of existing mortgages is the Federal National Mortgage Association (FNMA), known to many as "Fannie Mae." (www.fanniemae.com/index.jhtml). The FNMA was originally organized by the federal government in 1938 to purchase FHA-insured mortgages. The association was reorganized in 1968 as a quasi-private corporation whose entire ownership is private. Fannie Mae raises capital by issuing corporate stock which is actively traded on the New York Stock Exchange and by selling mortgages out of its portfolio to various investors. Over the past 20 years, Fannie Mae has purchased many times more than it has sold. At the end of 1983 current mortgage holdings exceeded $80 billion, the majority being FHA-insured.

The mortgage purchase procedure used by FNMA is conducted through an auction process referred to as the Free Market System Auction. Periodically, the association accepts bids from approved lenders as to the amount, price and terms of existing mortgages that these lenders wish to sell Fannie Mae. Upon deciding how much money it will spend during a given time period, FNMA notifies the successful bidders (determined by those mortgages offered for sale that will generate the highest yield to FNMA), and these bidders have a certain time period in which they can choose to deliver the mortgages. Once the mortgage has been delivered to Fannie Mae, the originator of the mortgage continues to service the loan(collect monthly payments, escrow property taxes, etc.) and for this service the originator receives a servicing fee.

The 2005 Fannie Mae loan limit for a single-family home is $333,700. The maximum amount for any Fannie Mae mortgage in Alaska, Hawaii, and the U.S. Virgin Islands is 50 percent higher than our loan limits in the rest of the country. Generally, any mortgage above this limit is considered a "jumbo loan," and will carry a higher interest rate. Limits for multi-unit loans for 2005 will be as follows: two-family loans $460,400; three-family loans $556,500; and four-family loans to $691,600. The 2005 loan limit for second mortgages will be $179,825.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GINNIE MAE)

When the Federal National Mortgage Association reorganized in 1968, the Government National Mortgage Association (GNMA) (www.ginniemae.gov/index.asp) was completely separated as a legal entity. Referred to as "Ginnie Mae," this participant in the secondary mortgage market is a wholly-owned government corporation under the office of the U.S. Department of Housing and Urban Development (HUD). While FNMA is involved with the selling and purchasing of existing mortgage, Ginnie Mae is responsible for the liquidation and special assistance functions previously carried out by FNMA. GNMA receives its funds from U.S. Treasury and mortgage operations. Ginnie Mae is also involved with the mortgage securities pool plan and tandem plan. GNMA also makes financing available to certain urban renewal projects, elderly housing and other high-risk mortgages.

FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC)
In 1970, under the Emergency Home Finance Act, the Federal Home Loan Mortgage Corporation (FHLMC) or "Freddie Mac" (www.freddiemac.com/) was created as a wholly owned subsidiary of the Federal Home Loan Bank System. Freddie Mac was established as a secondary mortgage market for savings and loan associations who are members of the FHLBS.

The creation of FHLMC was of added importance since S&Ls make such a high percentage of the total conventional residential mortgages and many of these lenders would like to roll over their mortgages. While Fannie Mae deals heavily in FHA and VA mortgages, the majority of mortgages in Freddie Mac's portfolio are conventional. In recent years, this agency has referred to itself as The Mortgage Corporation. Funds to finance Freddie Mac operations and mortgage purchase programs come from: (1) participation certificates (mortgage backed securities) and (2) convertible subordinated debentures. The maximum loan to value ratio for an owner occupied residence under Freddie Mac typically is 95 percent. Log onto www.freddiemac.com/sell/factsheets/ltv_tltv.htm for an updated loan to value ratios under various programs.

CLASSIFICATION OF MORTGAGES

In no area of real estate terminology is there more diverse classification of terms than with real estate mortgages. The following classification is offered as an aid in explaining the more common typed of mortgages used in financing real estate.

METHOD OF PAYMENT

STRAIGHT-TERM MORTGAGES
Prior to the Great Depression of the 1930s, the straight-term or term mortgage was the common means of financing residential real estate. Under this method of payment, interest only is paid periodically (monthly, quarterly, annually) and the initial amount borrowed, the principal, is not paid until the last day of the loan period. Typically, term mortgages covered short periods of time--three to five years--and there was normally little intent by either the borrower to repay the principal or the lender to demand payment of the principal. The original amount borrowed was either extended for another term at an agreed upon interest rate or the borrower would negotiate with a new lender and pay off the old loan. However, as a result of financial conditions during the Depression and the National Housing Act of 1934, which among other things established the Federal Housing Administration, term mortgages became less popular. Borrowers during the Depression were unable to pay the principal when it became due. Because of the tightness in the money supply, lenders were unable to roll these loans over, and thus had to foreclose. Over a million families lost their homes during this time. The failure of the money market led to the creation of the Federal Housing Administration and increased usage of the amortized mortgage. Today, term mortgages are generally used only in the financing of land and construction.

FULLY-AMORTIZED MORTGAGES

Unlike the term mortgage where none of the principal is repaid during the life of the mortgage, a fully amortized mortgage requires periodic (typically monthly) payment of both interest and principal. The first part of the payment covers interest on the outstanding debt as of the payment date, and the remainder of the payment reduces the outstanding debt. At the maturity date, the balance has been reduced to zero. The initial payments will consist of more interest than principal reduction; however, the percentage of the periodic payment reducing the subsequent payment is made.

Fully-amortized mortgages are currently the normal means of securing permanent financing. The maturity date is usually much longer than with a term mortgage. For residential property, this type of mortgage usually covers 20 to 40 years and for commercial property the time period is 10 to 15 years.

PARTIALLY-AMAORTIZED MORTGAGES

Partially-amortized mortgage also requires periodic repayment of principal. However, unlike the fully-amortized mortgage is not zero; rather, the principal has been only partially reduced. The remaining balance is referred to as a balloon payment.

As a result of higher interest rates and inflation during the early part of this decade, this type of mortgage has become more common in residential financing. Today, some lenders make loans based on, for example, a 30-year amortization schedule but with a five-year term. Thus, at the end of five years, the outstanding balance is due.

BUDGET MORTGAGES

Besides paying interest and principal each period, a borrower can also be required to pay a certain percentage of annual property taxes and property insurance. For a residential mortgage this means one-twelfth of the property taxes and one-twelfth of the property insurance each month. The advantage to the borrower is that a budget mortgage allows the spreading out of these annual expenses into 12 equal payments. For the lender, who normally places these funds into an impound or reserve account, the advantage is the assurance that these expenses will be paid when due.

TIME PERIOD

CONSTRUCTION LOANS

These are also referred to as interim financing. A construction mortgage provides the funds necessary for the building or construction of a real estate project. The project can be a residential subdivision, a shopping center, an industrial park or any other type of property requiring financing during the time required to complete construction. Normally, the full amount to be loaned is committed by the lender, but the actual disbursement is dependent upon the progress of the construction. Funds are sometimes distributed to the borrower in a series of draws, depending upon the work required by the lender. Another method used is for the developer to submit all bills to the lender, who in turn pays the bills. In either case, interest is paid on what has been distributed and not on the total amount to be borrowed.

Typically, the interest rate charged is tied to the lender's prime rate, which is the interest rate charged to the lender's AAA customers. In addition to interest, the borrower is normally charged a 1% or 2% origination fee. Since construction mortgages are considered high-risk loans, a lender often requires a standby or take-out commitment from a permanent lender. A standby or take-out commitment means that another lender will provide permanent financing when a certain event, generally the completion of the project, occurs. Sometimes, permanent lenders require a certain percentage of a project to be rented before the financing is provided. This assures the construction lender that permanent financing will be available to repay the construction loan if the project is completed and other conditions are met.

PERMANENT LOANS

The permanent loan is used to repay the construction loan. Whereas a construction loan is typically short term, permanent financing normally covers 10 years or more. Permanent financing will either be fully- or partially-amortized through periodic mortgage payments.

Since the payment will be paid from the income generated from the project, the lender can make the amount borrowed contingent upon a certain amount of the available space being leased prior to closing the loan transaction. For instance, the developer of a shopping center might be able to borrow $2,000,000 if 80% of the available space is leased. This could result in a gap in the capital needed for financing.

GAP FINANCING

Gap financing often covers a shorter period of time than permanent financing and usually at a substantially higher interest rate. First of all, it is a junior mortgage, which means the lender does not have the same lien position as the permanent lender; second, there is more risk involved.

Normally, gap financing involves different types of financing. For instance, a commercial bank might provide the construction financing and a real estate investment trust the gap financing. Quite often all of this is arranged through a mortgage broker. Gap financing may also be needed if the conditions set by the permanent lender have not been met and the construction financing has expired. In this case, the gap financing would be senior financing.

SENIOR INSTRUMENTS (FIRST MORTGAGES)

To hold the first mortgage on real estate means that the lender's rights are superior to the rights of subsequent lenders. This means less risk to the lender, which normally results in a lower interest rate charged to the borrower than charged on second or junior mortgages. Certain lenders only make first mortgages due to regulatory requirements; others limit mortgages to these senior instruments due to company policy.

CONVENTIONAL MORTGAGES

The majority of permanent residential financing provided in this country is through the fully-amortized conventional mortgage. The term "conventional" refers to a mortgage that is not FHA-insured or VA-guaranteed. Since there is not third party to insure or guarantee the mortgage, the lender assumes full risk of default by the borrower. A lender's decision to make a conventional loan is usually dependent upon: (1) the value of the property being used to secure the debt and (2) the credit and income position of the borrower. As more and more conventional loans have been made, the loan-to-value ratio (relationship between amount borrowed and the appraised value of the property) has continued to increase, even though most lenders still limit the amount they will lend to no more than 80% of value unless private mortgage insurance (PMI) is carried. This down payment requirement is higher than with either FHA or VA loans. As the market price of residential real estate has continued to increase, more cash down payment has been required of the borrower, and thus many people have been eliminated from financing with a conventional mortgage. With both insured and guaranteed mortgages, people have been able to purchase real estate with a smaller cash down payment.

FEDERAL HOUSING ADMINISTRATION INSURED MORTGAGES (FHA)

In 1934, Congress passed the National Housing Act, thus establishing the Federal Housing Administration (FHA) which immediately resulted in more construction jobs for the unemployed. This in turn helped to stimulate the depressed economy. In order to provide the means by which these new homes could be purchased, FHA (www.fha-home-loans.com/) established an insurance program to safeguard the lender against the risk of nonpayment by people purchasing these homes. The result was that the majority of homes financed were FHA insured. Even though the percentage of homes insured under FHA coverage has continued to decrease, the standards and requirements under FHA programs have been credited with influencing lending policies and techniques in financing residential real estate.

Under an FHA-insured mortgage, both the property and the borrower must meet certain minimum standards. FHA loans allows first time home buyers and current home owners to buy a home with less than 3% down payment or FHA mortgage refinance up to 97% of the homes value. The borrower is charged an insurance fee of one-half percent on the unpaid balance. If a purchaser using FHA financing is paying more than the appraised value, the difference between the appraised value and the sales price must come from the purchaser's assets. Borrowers are not permitted to obtain second mortgages to use as down payments. Also, FHA sets limits as to the maximum loan origination fee charged by the lender. The subject property must be appraised prior to the loan being made; this fee is normally absorbed by the mortgagor. FHA insures these loans for up to 30 years. Thus, the low closing costs, the relatively low down payment and the long amortization period permitted under FHA have all aided in providing residential financing for millions of people who otherwise would not have been able to purchase a home. On a conventional mortgage, the interest rate is determined by the lender rather than by the Secretary of Housing and Urban Development. This rate is periodically raised or lowered to reflect changes in the cost of money, although historically, interest rate on FHA mortgages have been slightly below conventional mortgage interest rates. In addition, borrowers financing with FHA coverage may be charged discount points since points can be paid by either the buyer or the seller. In recent years, FHA has expanded its operation; currently, the agency administers a number of programs dealing with housing. The basic home mortgage program is normally referred to as 203(b), and the program which provides insured mortgages for low or moderate income families is referred to as 221 (d)(2).

VETERANS ADMINISTRATION LOAN GUARANTY PROGRAM (VA)

Included in the Servicemen's Readjustment Act of 1944 were provisions covering the compensation to lenders for losses they might sustain in providing financing to approved veterans. The maximum guaranteed amount, which has periodically been increased, is set by the VA (www.va.gov/ and www.homeloans.va.gov/faqelig.htm) as is the maximum interest rate charged by lenders. There are no provisions on the upper limits of the loan-to -value ratio, which means that it is quite common for an approved veteran to receive 100% VA financing. It should be noted that some lenders set limits on how much they will finance using VA financing. VA guarantees loans up to 30 years. The money in a VA loan comes from federal government.

To qualify for VA financing the veteran applies for a certificate of eligibility. The property as well as the borrower must qualify. If the property is approved a certificate of reasonable value is issued. As is true with FHA, junior financing is essentially prohibited under VA. (Junior financing is rare and its terms keep it rare.) Coverage also extends to the financing of mobile homes, condominiums and nonreal estate purchases such as farm equipment and business loans. A VA loan is assumable; however, unless released by the lender, the veteran who borrowed the funds initially remains liable to the lender. Lenders cannot insert prepayment penalties under either VA or FHA loans. A mortgage without a prepayment penalty is commonly referred to as an open mortgage while one that cannot be prepaid is a closed mortgage. VA limits the points charged to the buyer to one. Any other points must be paid by the seller.

CALIFORNIA FARM AND HOME PURCHASE PROGRAM (CAL-VET)

The Cal-Vet (www.cdva.ca.gov/calvet/) began in 1921 as a program to assist California veterans in acquiring suitable farm or home property at low financing cost. It is a complete financing program within the Cal-Vet office. The funds for financing come from the authorized sale of state general obligation bonds approved by the voters, and most recently from the sale of revenue bonds authorized by the legislature. The department purchases the property from the seller, and then sells to the qualified veteran on a land contract. The veteran holds equitable title, while the department holds legal title.

To be eligible, veterans must use their benefits within 30 years of their date of release from active military duty. No time limit is placed on those who were wounded, disabled, or prisoners of war. Nearly any veteran wanting to buy a home in California is eligible. They currently have funds for all qualified wartime era veterans, regardless of when they served in the military. They also have funds available for peacetime veterans who meet the criteria for Revenue Bond funds (first-time homebuyers or purchasers in targeted areas who meet income and purchase price limitations). There are no residency restrictions. Veterans are eligible regardless of where they entered service. Only one loan may be active at any time; however, a second loan is possible if the veteran served during multiple war periods.

The loan includes single-family homes, condominiums, town houses, and mobile home on land owned by the borrower.

INSURED CONVENTIONAL LOANS

An insured conventional loan is one which is insured by a private (nongovernmental) insurance company. The establishment of FHA-insured loans and VA-guaranteed loans resulted in higher loan-to-value ratios and longer amortization periods than lenders were willing to offer under conventional financing. As the costs of housing continued to increase year after year, some means of providing protection against loss of high loan-to-value conventional mortgages was needed. Thus, in 1957, the Mortgage Guaranty Insurance Corporation (MGIC) or "Magic" as it is normally referred to, established a private mortgage insurance program (PMI) for approved lenders. MGIC offered the lender quicker service and less red tape than FHA. Today private mortgage insurance companies insure more loans than both FHA and VA. Unlike FHA which insures the whole loan, PMI insures only the top 20 or 25% of the loan, and the insurer normally relies on the lender to appraise the property. While the majority of PMI loans are for 90% loan-to-value, coverage does extend to a maximum of 95%. On a 90% loan, the borrower is normally charged one-half of 1% at closing and one-fourth of 1% of the outstanding balance each year thereafter. With a 95% loan, the rate is normally 1% of the loan at closing plus 1/4% of the outstanding balance each year the insurance is carried. Since only the top portion of the loan is covered, once the loan-to-value drops below a certain percentage, the lender may terminate the coverage, and thus, the insurance premium is no longer charged to the customer. In case of default, the insurance company can either pay off the loan or let the lender foreclose and pay the loss up to the amount of the insurance coverage.

JUNIOR INSTRUMENTS (SECOND MORTGAGES)

A junior mortgage is one which has a lower priority or lien position than a first mortgage. A third or even a fourth mortgage is also classified as a junior mortgage. What established a mortgage as being a junior mortgage is that it was recorded after the first mortgage was recorded and thus its lien position is inferior to the first mortgage. "Balloon payment" is commonly associated with junior loans.

PURCHASE MONEY MORTGAGES (PMM)

The term purchase money mortgage has a dual meaning in real estate financing. All mortgage loans for real estate purchases are designated purchase money mortgages by lenders, and thus all the different types of mortgages explained could be classified as purchase money mortgages. The second meaning of the term explains what happens when the buyer does not have the necessary cash and the seller agrees to take back a part of the selling price in the form of a purchase money mortgage. Such a mortgage is ordinarily subordinated to take a second-lien position since the primary lender will require a first lien position before making the loan. For the purchaser, this means less cash and possibly an interest rate on the PMM less than if those same dollars were borrowed from a primary lender. The seller can possibly induce a sale not otherwise possible by agreeing to take back a purchase money mortgage. The seller is protected in that a PMM places a lien on the property the same as any other second mortgage.

HOME-IMPROVEMENT LOANS

In recent years, one result of increased housing costs and higher market prices has been the relatively fast equity build-up for owners of real estate. To an owner, this equity can become a source of capital that can be drawn out of the home for home improvements, personal or business reasons. Numerous commercial banks and finance companies make short-term (three to five years) junior mortgages based on a percentage of the homeowner's equity. Since they are junior mortgages, such loans normally carry an interest rate three or four percentage points above that charged on senior instruments.

WRAPAROUND MORTGAGES

As its name implies, a wrap-around mortgage (or deed of trust) is a junior mortgage that wraps around an existing first mortgage. It is also called *all-inclusive trust deed (AITD).* This method of obtaining additional capital is often used with commercial property where there is substantial equity in the property and where the existing first mortgage has an attractive low interest rate. By obtaining a wrap-around, the borrower receives dollars based on the difference between current market value of the property and the outstanding balance on the first mortgage. The borrower amortizes the wrap-around mortgage which now includes the balance of the first mortgage, and the wrap-around lender forwards the necessary periodic debt service to the holder of the first mortgage. Thus, the borrower reduces the equity and at the same time obtains an interest rate lower than would be possible through a normal second mortgage. The lender receives the leverage resulting from an interest rate on the wrap-around greater than the interest paid to the holder of the first mortgage.

EXAMPLE

The sale price is $300,000. There is a mortgage balance of $200,000 payable at 9% interest. The buyer will pay $30,000 cash down and agrees to pay the balance at 11%. By using the wrap-around mortgage, the seller can have the buyer agree to a mortgage of $270,000 at 11%; the buyer makes the applicable monthly payment to the seller. The seller, in turn, continues to make payments on the underlying first mortgage which was written at 9%. This means that the seller, in his or her role as a mortgagee, now earns 11% on $70,000 (the difference between the new mortgage of $270,000 and the existing mortgage of $200,000) and 2% on the existing $200,000 loan.

The seller grants a deed to the buyer in the regular way. Note that for this method to work, the original lender must be agreeable to the seller transferring title.

TYPES OF PROPERTY PLEDGED

PACKAGE MORTGAGES

Quite often the sale of real property includes certain items and equipment as part of the sales price. Rather than acquiring separate mortgages on each of these items, the buyer can, through the use of a package mortgage, finance both the real property and the personal property. In residential real estate, a builder might include a stove, refrigerator, dishwasher or air conditioning in the sales price. For commercial real estate, certain equipment or furniture is often included in the sales price. The advantage to the purchaser is that these items can be financed over a much longer period and at a much lower interest rate than if a separate financial instrument was used. For the builder or seller, these items often serve as inducements used in financing the sale.

BLANKET MORTGAGES

A blanket mortgage is often used by a developer to cover more than one parcel of land under the same mortgage. For example, a developer buys a large tract of land and plans to subdivide the land into 100 lots and then build homes on the lots. Rather than going to the expense and time of obtaining 100 separate mortgages, one blanket mortgage covering all the lots is obtained. Since the developer will probably be developing a few lots at a time, the mortgage will include a partial release clause which means that as the debt is paid, individual lots will be released from the mortgage. Thus, the developer can pay off part of the mortgage, have a certain number of lots released, build on the lots and then sell them free and clear from the lien that still exists on the unreleased lots.

MOBILE HOME LOANS

Certain lenders, although not all, make loans on mobile homes. Typically, the amount financed is far much less than the average residential loan, and the amortization period is much shorter, perhaps seven to 10 years, even though longer terms are available under both FHA and VA financing. The amortization period is usually shorter since, unlike a permanent home, a mobile home normally depreciates in value, and thus, the lender wants to be repaid over a shorter period of time. A fear of some lenders is that since mobile homes are not permanently affixed to the land, the security for the loan, the mobile home, can be moved by a dishonest borrower. Thus, not all lenders make mobile home loans.

LAND CONTRACTS

Also referred to as an installment sales contract, a land contract involves the seller's accepting a down payment on a parcel of land and a series of periodic payments of principal and interest. However, unlike other types of financing, title to the property does not pass until the last payment has been received. Although called a land contract, this means of financing can also be used to purchase improved land. Rules relating to land contracts differ from state to state. For instance, some states require that title be passed when a certain percentage of the loan has been paid by the borrower.

LEASEHOLD MORTGAGES

Sale-leasebacks are used by owners of commercial property as a means of raising capital. The process involves the simultaneous selling and leasing back of the property usually through a net lease. The advantages to the seller include the freeing of capital previously tied up in the project and the inclusion of the rental payment as a legitimate operating expense for income tax purposes. For the investor, the rental payment represents a return on investment and any depreciation for tax purposes or increases in value due to market conditions accrue to the investor.

LAND LEASES (GROUND LEASES)

A ground lease is ordinarily a long-term lease for a parcel of unimproved land. The tenant pays what is known as a ground rental and pays all taxes and other charges associated with ownership. The landlord receives a net amount which may have an escalation clause to periodically adjust the ground rental so that the property reflects the changing values of the land.

Normally, a ground lease contains a subordination clause. A subordination clause is an agreement that the first lienholder will agree to take a junior position to another lienholder. Without a subordination clause, it may be more difficult to construct improvements on the land. A lender, without a subordination agreement by the lessor of the land, will only consider the value of the leasehold in making a loan, while with a subordination will consider the full value of the property.

In certain parts of the country, most notably Baltimore, Maryland, the land under residential real estate is leased through a long-term lease agreement whereby the owner of the land receives periodic rent for the use of the land. Such an agreement covers an extended period of time, possibly 99 years, renewal at the lessee's option and results in a lower purchase price of the home, since the land is not owned in fee simple. Thus , less money has to be borrowed. The owner of the ground rent has a superior lien position to that of the lender, and therefore the lender normally requires the borrower to include the ground rent as part of the monthly debt service. State statutes regulate land leases.

FLEXIBLE FINANCING TECHNIQUES

As conditions and needs change, new and more flexible financing techniques have been introduced by lenders. The switch from term mortgages to fully-amortized mortgages and the increase in the loan-to-value ratio are examples of such action. While no one is sure as to exactly what lies ahead, a number of different types of financing techniques are currently being used.

GRADUATED PAYMENT MORTGAGES (GPM)

Under the level annuity, fully-amortized mortgage, each month's payment is exactly the same. The obvious advantage is that when securing a mortgage the borrower is assured of a level or constant mortgage payment. However, for some purchasers the required monthly payment is so high that a lender will not make the loan simply because the borrower's income is insufficient. With a GPM, monthly mortgage payments start at an amount less than would be required under a level annuity payment and increase periodically over the life of the mortgage. Therefore, the borrower can finance a larger purchase than if the monthly payment were level throughout the life of the mortgage. FHA has a number of GPM programs currently available.

FLEXIBLE LOAN INSURANCE PROGRAM (FLIP)

This is a graduated payment mortgage developed to overcome the negative amortization aspects of the GMP. The key to the FLIP mortgage is the use of the buyer's down payment. Instead of being used as a down payment, the cash is deposited in a pledged, interest-bearing savings account where it serves as both a cash collateral for the lender and as a source of supplemental payments for the borrower during the first few years of the loan. During the early years of the mortgage, each month the lender withdraws predetermined amounts from the savings account and adds them to the borrower's reduced payment to make a full normal mortgage payment. The supplemental payment decreases each month and vanishes at the end of a predetermined period (usually five years). By using this type of program, a borrower is likely to qualify for a larger loan than with a conventional fully- amortized mortgage.

REVERSE ANNUITY MORTGAGES (RAM)

Reverse mortgages are a way for seniors to enjoy their retirement as well as cope with inflation and what comes with it. The reverse mortgage enables older homeowners to convert part of the equity in their homes into income without having to sell, give up title or make monthly payments. Homeowners must be 62 or older to be eligible. In a reverse mortgage, the lender pays the homeowner – the opposite of a traditional mortgage where the homeowner pays the lender. The homeowner has the option to receive monthly payments, a lump sum payout, a line of credit, or any combination.

ADJUSTABLE RATE MORTGAGES (ARM)

It is also known as variable rate mortgages (VRM). Under ARM, the interest rate charged by the lender can vary according to some reference index not controlled by the lender, such as the Cost of Living Index, the San Francisco District 12 Cost of Funds, the 1-year United States T-Bill, and the London Interbank Offered Rate (LIBOR). For the lender, this means that as the cost of money increases, the interest being charged on the existing mortgage can be increased, thus maintaining the gap between the cost of money and return. Either the monthly payment, the maturity date or both can be changed to reflect the difference in interest rates. In addition, the mortgage usually stipulates a maximum annual charge and a maximum total increase in the interest the lender may charge. Under current regulations established by the FHLBB, the interest rate may not be raised more than 2.5% points above the initial rate. The rate can be changed each 6 month, with no more than 1/2 of 1% change each 6 months.

The 11th District Index, which is probably the most widely used benchmark for ARMs is computed by the Federal Home Loan Bank of San Francisco. It reflects the cost of deposits at savings and loans in California, Arizona and Nevada. Most ARMs written in California in recent years are tied to this index.

RENEGOTIATED RATE MORTGAGES (RRM)

The renegotiated rate mortgages, also known as the rollover mortgages, help the lender to avoid being locked in to an interest rate that is below the cost of money. Here, at intervals such as 3 to 5 years, the loan is renewed at the going rate; the borrower is guaranteed at least a 30-year term and can pay off the loan without penalty at any time. If rates go up, so would payments if the loan was renewed, but the borrower could shop around to get the best deal.

SHARED APPRECIATION MORTGAGE (SAM)

A shared appreciation mortgage is a type of equity participation loan in that in exchange for charging a below-market interest rate, the lender receives a predetermined percentage of any increase in value of the property over a specified period of time. For the lender, the money received from the appreciation of the property increases the effective yield on the investment. The borrower, by agreeing to share the interest rate, in turn reduces the monthly mortgage payment. A SAM is normally written so that at the end of the shared appreciation period, the property will be appraised and the amount due to the lender through appreciation is due at that time.

DEFERRED INTEREST MORTGAGES

This financing technique is aimed at those people who only plan to live in a house for a short period of time. Under this mortgage, a lower interest rate and thus a lower monthly mortgage payment is charged. Upon the selling of the house, the lender receives the deferred interest plus a fee for postponing the interest that would normally have been paid each month.

PARTICIPATION MORTGAGES

This term, when used to classify types of mortgages, has numerous meanings. One common type of participation mortgage is when more than one mortgagee lends on a real estate project, such as with a large commercial project. A second type of participation mortgage involves more than one borrower being responsible for a mortgage, such as with a cooperative apartment. Finally, a participation mortgage also represents an agreement between a mortgagee and a mortgagor which provides for the lender having a certain percentage ownership in the project once the lender makes the loan.

SALE-LEASEBACK

A sale-leaseback is a situation in which an owner of property sells the property to an investor and then leases the property back, usually for a twenty-or 30-year term.

EXAMPLE

Jay sells a property to Laura for $500,000 and agrees to lease it at a net rental to give her a 10% return on her investment. Jay will receive $500,000 in cash and will keep the property, pay Laura a net amount of $50,000 each year. At the end of the term, the property will revert to Laura.

HELP BUYERS COMPARE MORTGAGE OPTIONS

Buyers face a big challenge in choosing a mortgage, but you can help them get off to a good start. How do you know which mortgage option is best for a particular buyer? Even if economic experts could agree about what will happen to interest rates during the next year, you still shouldn't choose a type of mortgage for a buyer. What you should do is stay as informed as possible about mortgage options. Then you can give buyers information that will help them make informed decisions. This section discusses some of the mortgage instruments currently used, as well as some of the features of those mortgages.

FIXED-RATE MORTGAGE

The most popular and traditional mortgage is the fixed-rate, which involves making regular payments based on a fixed interest rate. Unless interest rates exceed "comfortable" levels (typically about 10 percent), buyers are likely to choose this type of mortgage. According to the Federal National Mortgage Association (Fannie Mae), first time buyers often choose fixed-rate mortgages because they want the security of stable and affordable payments. Also according to Fannie Mae, financially motivate buyers may choose fixed-rate mortgages because they want low monthly payments throughout the loan term. For instance, because homes in some areas may appreciate more slowly than those in other areas, some people prefer to make low monthly payments so that they can put the money they save into other investments that bring greater returns. Also, buyers can reap the greatest cumulative tax deductions available over the loan term.

Generally, lenders require 20 percent down payments on conventional fixed-rate mortgages, but with Federal Housing Administration (FHA) insurance, only 5 percent is required. Currently, however, FHA insurance is available only on loans less than $101,250.

Also, private mortgage insurance (PMI) can help buyers purchase a home with only a 10 percent down payment. As the name implies, buyers purchase PMI through private companies but lenders typically acquire the insurance for the buyers. First-year premiums are usually between .35 and 1.65 percent of the total loan amount, and depending on policy requirements, buyers must pay the premiums either in advance or monthly.

A twist on the 30-year fixed-rate mortgage is the shorter-term fixed-rate mortgage, with either a 10- or 15-year loan term. These shorter terms require larger monthly payments than a

30-year term, but the benefits that often attract buyers include the lower interest rates, faster equity buildup, and a substantial interest savings over 30-year mortgages.

With biweekly fixed-rate mortgages, payments are about one-half those of monthly fixed-rate mortgages with the same amortization schedule, and they're drafted automatically from the borrower's bank account every other week. Borrowers make the equivalent of 13 monthly payments in just 12 months, and as a result, they save on interest and their equity builds faster. Biweeklies amortize every two weeks rather than monthly, and loan amortization terms of 10,15,20, and 30 years are available.

ADJUSTABLE-RATE MORTGAGES

Adjustable-rate mortgages (ARMS) are a little riskier than fixed-term mortgages. In exchange for lower initial interest rates, borrowers take the risk that if lending rates rise, their payments will also rise.

With ARMs, rates are adjusted during the term of the loan according to changes in market interest rates. Borrowers typically choose a six-month or one- or three-year ARM, and as the names imply, the rate remains stable for the first six months, year, or three years. (There are, of course, other kinds of ARMs, which are also classified according to the frequency of their payment adjustments.) A per adjustment cap and a lifetime cap on the level to which the interest rate may be adjusted can help reduce some of the risk, and these are available on some ARMs, as are 15- and 30-year loan terms, and options to convert to fixed-rate mortgages.

Why do some borrowers opt for ARMs? Those who expect to move within a few years will often choose an ARM because of the low initial interest rates and then resell the home before the rates are adjusted. Borrowers refinancing their current mortgages may also choose ARMs if the lower initial interest rates can make up for the transaction costs of refinancing.

Remember, though, lenders use different indexes on which to peg their ARMs. The index used will determine the payments during the loan term. For example, cost-of-funds indexes are tied to the interest rates on savings accounts. Many lenders, however, now use the one-year U.S. Treasury securities index or the 11th-district cost of funds index to adjust their ARMs.

Also, treatment of closing points can be different with ARMs. A few lenders allow buyers to spread the cost of closing points in equal monthly installments over the first two years of the loan. Buyers should check the deductibility of these payments with their tax adviser.

NEGATIVE AMORTIZATION

With most loans, the payments cover the principal and interest, and the borrower will have repaid the loan by the end of the loan term. But some borrowers are taking more risks by using negative amortization loans. In those cases, monthly payments fall short of what the borrowers must pay to cover both the principal and the interest of the loan, and at the end of the year, the borrowers actually owe more than they owed before they make 12 payments. Why would a borrower do this? Lower monthly payments are available with negative amortization loans, and most often, borrowers who take this risk are buying in markets with extremely high prices. Many gamble that their home will appreciate enough to cover the difference between their payments and the new loan amount.

TAKING KNOWN RISKS

Some borrowers are willing to take risks if they know the risks in advance. With graduated payment mortgages (GPMs) or growing equity mortgages (GEMs), payments increase during the loan term. Borrowers can plan for the larger payments because they know exactly how much the payments will increase. The difference between GPMs and GEMs is the treatment of the amortization schedule. GEMs are calculated on 30-year fixed terms, even though payments increase during the loan term. As a result, a 30-year loan is often paid within 15 to 20 years. With GPMs, the increase payments are scheduled within the 30-year term, and the "overpayments" are applied directly to the loan principal. The FHA offers five different types of GPMs, and the Veterans Administration (VA) offers its own GPM and GEM plans.

LET THE VA TAKE RISKS

Except for its GPMs and GEMs, loans guaranteed by the VA require no down payment, and a builder or seller may pay closing cost for the buyer.

The VA also offers veterans a buyer-down purchase plan in which the seller pays the lender to lower the borrower's interest rate either temporarily or permanently. In permanent buy-downs, sellers will typically offer to make the interest rate 1 percent below the maximum rate set by the VA for the entire 15- or 30-year loan term. With temporary plans, the 3-2-1 option is common. The interest rate is reduced 3 percent during the first year, 2 percent during the second year, and 1 percent during the third year. Then payments increase to normal levels for 30-year terms. Finally, to increase the options when a borrower decides to resell, no VA loans have due-on-sale clauses. Thus, another buyer may assume the veteran's loan at the original interest rate, or the veteran may incorporate a second mortgage, a wraparound, a contract for deed, or a lease purchase without the original lender's approval.

LET THE FHA TAKE RISKS

Not only does the FHA insure loans for lenders but its insurance makes it possible for buyers to purchase a home with a small down payment. Under the FHA's 203b plan, virtually any U.S. resident 18 years or older can purchase a home with a 15- or 30-year fixed-rate loan and a 3 percent down payment on the first $25,000 of value and closing cost and 5 percent on the remainder. Another FHA option is the shared equity mortgage (SEM), whereby a marginal buyer can pair up with a relative or investor to purchase a home. With an SEM, loans often go as high as 97 percent of the home's value. Each investor owns a percentage of the home, and monthly payments are based on those percentages.

SELLER FINANCING

If buyers are considering a home with an assumable mortgage at a fair interest rate or if the sellers have already paid their mortgage, remember to consider seller financing. With seller financing the seller determines the sales price and then acts much like a lender. He determines the amount of down payment necessary and the other terms of sale.

Seller financing becomes more common when interest rates are high and buying a home is out of reach for many who could otherwise afford it. But regardless of interest rates, this option helps qualify people to buy who might not be able to qualify for a loan through a lending institution or who may have the income to afford monthly payments but not the cash for a down payment. With seller financing, borrowers whom lenders might consider marginally qualified not only may qualify to buy but also may save money because closing costs are often nonexistent or less expensive than with lender financing. Why would a seller take the risk? Often, seller financing produces returns that are substantially higher than those of most other investments. Also, seller financing is treated as an installment sale for tax purposes, and the seller will be taxed only on the proportional amount of gain received each year. Finally, if the buyer defaults, the seller can take the property back under the contract or, if absolutely necessary, he can foreclose on the property.

A seller can also offer a wraparound mortgage to a buyer who already owns a home. With this option, the seller makes a money advance to cover or "wrap" the balance due on the old mortgage and the amount on the new loan at an interest rate below market levels. The term of the wrap is the time left on the old mortgage. So with the seller's help, the buyer's monthly payment is substantially less than for a new first mortgage at the higher interest rate.

HELPING FIND THE RIGHT OPTION

Maybe some of the buyers you're working with want to purchase a home, but they want low monthly payments so that they can save for their children's college education. Or maybe some of your prospects haven't saved enough money to afford a down payment on the home they're interested in, but they want to invest in a home rather than pay rent each month.

Today's buyers have many financing options, and the challenge for them is to find the option that best suits their special circumstances. Your knowledge about their options can help ensure that their first step is the right one.

WHY QUALIFY THE BUYER?

According to an old blues lyric, "romance without finance ain't got a chance." So it is today with homebuying. Without finance, you can't close a sale. The point of the qualifying process is to quickly sort out buyers' needs from wants and relate their buying power to the available housing stock. It's a valuable service the real estate professional is uniquely qualified to provide.

You've probably seen people emotionally wrapped up in the idea of buying a home, but before they could find one and buy it, they had to work out financing details--that is, unless they were able to pay cash. How do you know whether prospective buyers can jump the financing hurdle?

The answer is by qualifying the buyer. The process usually starts with a qualifying interview soon after you've met the buyer. Build a rapport with the buyer during the interview that will allow you to discuss personal finances, obtain key numbers to determine whether the buyer meets current lender requirements, and gather information about the buyer's lifestyle and housing needs. Of course, as a salesperson, you're an expert in marketing homes, not real estate finance. You should make it clear to the buyer that you can provide information but the buyer should--and will-- eventually consult with an expert such as a lender. If you train buyers for the mortgage loan marathon, they'll come through in good shape.

Part of the job of getting transactions completed on behalf of sellers is knowing that the buyers you bring to the sale are qualified and only then showing them the houses you know they can afford. In today's hot markets, the seller is more interested than ever in financing. "Seller will carry back" is appearing more often in listings in California, multiple listing services (MLSs). Sellers want their properties sold fast, and financing is essential to almost every transaction.

BUILD TRUST AND RAPPORT

Since the mortgage menu is a full one, you have more to discuss with buyers at the qualifying session than ever before. If you can prepare your buyers to organize their finances and choose the best loan for their situation, they'll be well on their way to a loan approval. And you'll get a closed transaction.

Establishing rapport with buyers so that you can ask them details about their personal finances isn't always easy, but it's necessary. You'll run into some buyers who are reluctant to reveal their financial situation. You tell them what a lender will ask to get a loan approved. That way, buyers understand why it's important to provide key financial information.

Many of your buyers will be move-up buyers with equity and money to make the down payment. They'll probably fit into the range of lender requirements. But first-time buyers may not have a clear idea of what's affordable. Qualifying them initially will help ensure they'll see the houses they can afford (see Figure 1).

ASK FOR KEY NUMBERS

You would want to know gross and net income for the buyer--or for both husband and wife if they're co-borrowers--and get a rundown of debt payments and assets, including cash, certificates of deposit, and stocks and bonds.

Cash assets will tell you what buyers can afford for a down payment, which is a good indicator of how much house they can afford. But just make sure they've tapped every source of income they want to use for housing. If that's still not enough, they may have access to funds from co-borrowers, such as parents or other relatives. Income and debt will dictate the level of monthly housing payment a buyer can handle. With this information, you can estimate how much mortgage the buyer can afford. You find out the maximum that buyers can afford on the basis of income, debt payments, and the payment-to-income ratio. Then you determine the maximum for the fixed-rate mortgage and also for a variety of adjustable-rate mortgages (ARMs).

You have to elicit key financial information quickly to get the homebuying process moving.

SOME LENDERS LIKE CONFORMITY

The reason you need the financial data is that lenders have strict requirements. Often, you'll be working with a standard "conforming" loan and using the widely accepted lender requirements. Lenders set maximum loan amounts and limit housing expense to a certain percentage of total income and total debt. Starting January 2006, the maximum loan amount is $417,000. The income ratios are 28 percent for the housing ratio (payments, interest, taxes, and insurance (PITI) divided by gross monthly income) and 36 percent for the debt-to-income ratio (PITI and monthly debt divided by gross monthly income).

That's what's dictated by the secondary market—Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). They're among the largest single buyers of loans, so lenders adhere to their requirements.

Federal Home Loan Bank Board (FHLBB) gives you this maximum mortgage amount every year according to a formula established by law. The formula is based on the average purchase price of homes on which mortgage loans closed during October as determined by the FHLBB's monthly national survey of home prices. It's set to be effective January 1 every year.

A rising percentage of loans are sold to the secondary market, so lenders pay close attention to the changes in conforming loan limits. Loan to Value: Another Key Number

Another key figure for lenders is the loan-to-value ratio. This has proved to be an accurate predictor of risk in lending. Lenders like high down payments (20 percent or more) so that the loan-to-value ratio is 80 percent or less. Those loans are safe. A 90-95 percent loan-to-value ratio is somewhat more risky but not impossible to get. In today's competitive lending market, lenders vie to offer extra service to borrowers. They compete on the basis of extended loan-to-value ratios.

To cover the lender's risk, high-risk buyers usually pay extra in the form of private mortgage insurance (PMI). If you know that borrowers will need a high loan-to-value mortgage, you can explain ahead of time that PMI costs relatively little and provides the benefits of a lower down payment, more leverage, and more money available to the borrower. Then buyers won't be shocked at the extra payments.

LOANS MATCHING LIFESTYLE

During the qualifying interview, you must deal not only with key numbers but also with the buyers' housing needs and lifestyle. Find out what they want out of housing. The length of time that buyers want to stay in a house is as important as anything else in determining the mortgage they should choose. Short-term owners will benefit from an ARM's low rates in the early years. For some buyers, especially first-timers, it's a matter of searching for an affordable loan. First-time buyers and those who need a high loan-to-value mortgage require more work on your part. With them, your qualifying work is even more important. Some may simply be unqualified and need more time to save for a home. But don't rule out such buyers automatically.

Look for any special circumstances that affect financing. Is the buyer a veteran? Can he qualify for a Veterans Administration (VA) loan at below-market rates? Are there relatives who can help pay for the loan? Ask buyers about IRAs or pension plan funds that may boost their net worth and help them qualify; ask them about friends or relatives who may co-sign the loan with them.

Buyers' comfort level or risk aversion is also an important factor in the kind of financing they'll seek. ARMs and negative amortization loans carry more risk and uncertainty for the borrower, depending on the ups and downs of interest rates. Fixed-rate loans are considered more traditional and conservative.

AFTER YOU THINK THEY'RE QUALIFIED

After you've obtained the key numbers, you can do some "what if" calculations based on the buyers' lifestyle and housing needs. It'll help you arrive at a price range that's appropriate for them and an estimate of the maximum down payment, monthly payment, and mortgage amount they can afford.

When buyers have found a house and are ready to sign a sales contract, a lender will do the formal qualifying. If you think you have a special case on your hands or are unsure about it, you can rely on the lender sources you've cultivated.

KNOW WHEN TO CALL THE LENDER

Although financing knowledge is becoming increasingly important to salespeople, there are limits to their expertise. Know the limits of your involvement in finance. If something goes wrong with the buyers' you're no longer their friend who helped them buy their dream house but just the opposite. Every real estate professional knows a mortgage lender. Call the lender up and have that individual talk to buyers.

BE OPEN TO NEW TECHNIQUES

You'll need to work closely with lenders to keep up with the new mortgage programs they offer. Start out with, for instance, an intensive three- to four-hour financial seminar offered by a lender and then keep up-to-date by occasional visits with lenders. It's a good idea to check out new lenders and their loan programs by doing a dry run through the loan applications and reading the literature. Read critically. What are the advantages? Are there any hidden costs?

There is value in establishing a close relationship with three or four reliable lenders rather than shopping around for the lowest rate. You shouldn't shop rates for a quarter of a percent difference. Instead, you are better off working with your group of lenders to place most loans though you may try new lenders for hard-to-place loans. In return for loyalty, you may get good service and sometimes even a break on the rates.

KEEP ON TOP OF TRENDS

If you find out all you can about the top financial options in mortgage lending in your town, you'll provide a valuable service to buyers, assuring them of good market information. You'll also avoid the possibility that buyer's remorse will set in after a bad loan experience or a loan rejection.

As closely as real estate salespeople and lenders must work together today, all parties to the sale will benefit if the relationship and the transaction begin right.

FIGURE 1

QUALIFYING FOR CONVENTIONAL LOANS

Completing a work sheet like this one can give you and prospective buyers a better idea of how much house they can really afford. Once you've filled it out together, you'll also know what kind of financing hurdles may lie ahead.

Part 1--Determine Cash Available for the Down Payment

1.Sale of assets		$______________
2.Sale of previously owned home		$______________
3.Other available cash	+	$______________
4.Total available cash	=	$______________
5.Minus estimated closing costs	-	$______________
Cash available for the down payment	=	$______________

Part 2--Determine Gross Monthly Income

1.Annual salary of buyer(s)		$______________

2.Other annual income	+	$______________
3.Total annual income	=	$______________
	/	$____________
12 Gross monthly income	=	$ ______________

Part 3--Estimate the Affordable Monthly Payment (PITI)

A. Use the housing-expenses-to-income ratio

1.Gross monthly income (from Part 2)		$______________
2.Current housing-expenses-to-income ratio	x	______________
Affordable monthly PITI	=	$______________

B. Use the debt-to-income ratio

1.Gross monthly income (from Part 2)		$______________
2.Current debt-to-income ratio	x	$______________
3.Affordable monthly PITI with debts	=	$______________
4.Total debts exceeding ten months	-	$______________
Affordable monthly PITI	=	$______________

C. Compare the two monthly PITI amounts

1.Enter the smaller of the two amounts for affordable monthly PITI (compare the results of parts 3A and 3B)	=	$ ______________

Part 4--Estimate the Affordable Monthly PI

1.Actual affordable monthly PITI (from Part 3C)		$_______________
2.Estimated monthly taxes and insurance	-	$_______________
Affordable monthly PI	=	$_______________

Part 5--Estimate the Maximum Loan Amount
(Use an amortization table or calculator)

Maximum loan amount	=	$_______________

Part 6--Estimate Maximum Purchase Price

1.Down payment (from Part 1)		$______________
2.Maximum loan amount (from Part 5)	+	$______________
Maximum purchase price	=	$______________

Note: Adapted from RITE Financing Real Estate.

LEND A HAND WITH PAPERWORK

Be ready to interpret financial terms if they are a foreign language to buyers. A home is the biggest investment most people make, so buyers are anxious to finance it on the best terms possible. Today, more loan choices than ever face the would-be borrower. Once you've prequalified a buyer, the next step is usually answering the buyer's questions about mortgage loans. It's here that your knowledge of real estate finance can help you stand out from other salespeople. You must be thoroughly familiar with the mortgage market in your town. You must also know what loans are available and on what terms, and you must be ready to help buyers get through the application process.

GET TO KNOW LENDERS

To be proficient, you need to know which mortgages work best in a variety of market conditions. Keeping up with real estate finance can take some time and effort, but it's time well spent.

Lenders are ready to cooperate in the learning process. They, too, operate in a competitive marketplace, so they're ready to help you.

Although lenders all have their own products to sell, they're also good sources of general information about the field. To take advantage of this expertise, several salespeople advised, "Take a lender to lunch." Get to know the local lenders, and make it a habit to keep in touch with what's going on in the local and regional lending business. Even experienced salespeople need to learn continually because consumer demands shift and loan features change. After buyers have asked about loan types, they'll probably ask about rates. To illustrate the changes in interest rates, you can show buyers what has happened in the recent past. Remember, however, that lenders will be providing the buyer with specific rate and loan information as required by federal law. Since October 1988, lenders have been required to disclose to buyers applying for a loan how that particular program works. For example, if buyers choose one of the many adjustable-rate mortgage (ARM) products available, they'll get substantial information about interest rates.

Although you can't advise buyers on which loan to choose, you can direct them to sources of mortgage information.

LEARN THE LOAN MARKET

To give buyers the big picture, you can explain that almost all loans fit into one of two categories: fixed-rate or adjustable-rate. Even experienced move-up buyers may know that fixed-rate loans have recently appeared in equity building varieties. Borrowers can choose intermediate terms, such as 10, 15, and 20 years, as well as the traditional 30-year mortgage, which has been the backbone of real estate finance since the Great Depression.

Now well accepted, the ARM was a significant innovation. It let buyers take advantage of a low initial rate and payment and offered them the possibility of a downward adjustment in the future, depending on the performance of the index to which it was tied. Among the popular indexes, the 11th District average cost-of-funds index has been gaining in popularity because it has been less volatile and, therefore, a better buy for borrowers concerned with interest rate risk.

Learning the ARM loan means learning to compare not only initial rates but also indexes, margins, rate caps, and life-of-the-loan caps.

The convertible ARM is a relatively new mortgage product that combines features of adjustable- and fixed-rate loans. For those who want to hedge their bets, the convertible ARM is a fantastic product. It's adjustable, but it's conservative because it can convert to a fixed rate during a window period.

TYPES OF MORTGAGE LOANS

Loan Type	*Benefits*	*Drawbacks*
1.Fixed-rate, fixed payment a. Conventional 30-year mortgage	Fixed Monthly Payments for 30 years provide certainty of principal interest payments.	Higher Initial rates than adjustables.
b. Conventional 15 or 20 year mortgage.	Lower rate than 30-year fixed; faster equity buildup and quicker payoff of loan.	Higher monthly payments.
c. FHA.VA fixed rate mortgages (30-year and 15-year)	Low down payment requirements and fully assumable with no prepayment penalties.	May require substantial points; may have application red tap and delays.
d. “Balloon” loans (3-10 year terms)	May carry discount rates and other favorable terms, particularly when the home seller provides the loan.	At the end of the 3-10 year term, the entire remaining balance is due in a lump-sum or “balloon” payment, forcing the borrower to find new financing.
2.Adjustable rate a. Adjustable rate mortgage (ARM) – payment changes on 1-year,3-year, and 5-year schedules.	Lower initial rates than fixed rates than fixed-rate loans, particularly on the one-year adjustable. Generally assumable by new buyers. Offers possibility of future rate and payment decreases. Loans with rate “caps” may protect borrowers against increases in rates. Some may be convertible to fixed-rate plans.	Shifts far greater interest rate risk onto borrows than fixed-rate loans. Without “caps,” may also sharply push up monthly payments in future years.

b. Graduated-payment mortgage (GPM) – payment increases by pre-arranged increments during first 5 to 7 years, then levels off.	Allows buyers with marginal incomes to qualify. Higher incomes over next 5-7 years expected to cover gradual payment increases. May be combined with adjustable-rate mortgage to further lower initial rate and payment.	May have higher annual percentage rate (APR) than standard fixed-rate or adjustable-rate loans. May involve negative amortization-increasing debt owed by lender.
Growing-equity mortgage (GEM)-contributes rising portions of monthly payments to payoff of principle debt. Typically pays off in 15-18 years rather than 30.	Lower up-front payments, quicker loan payoff than conventional fixed-rate or adjustable-rate loans.	May have higher effective rates and higher down payments than other loans in the marketplace. Tax deductions for interest payments decrease over time.

LATEST MORTGAGE OPTIONS

With real-estate prices shooting persistently upward, first-time buyers are finding it tougher to get in the game. Who ever heard of a $500,000 starter home? Lenders have responded by devising some novel loan structures, mostly designed to cut payments in the early years. While many of these products make pricey homes available to people who otherwise couldn't afford them, they can be burdened with risk. Here are some of the latest mortgage options.

40-Year Mortgage. These products are similar to 30-year fixed-rate mortgages, except that borrowers stretch the payments out for an extra 10 years. Lenders, however, charge a slightly higher interest rate, up to half a percentage point. This type of loan is good for first-time buyers who don't plan on staying in the house for more than a few years, and are looking for lower monthly payments.

Benefits: A 40-year mortgage offers lower monthly payments than a 30-year loan. On a $300,000 mortgage at, say, 6% for a 30-year and 6.25% for a 40-year—a home buyer could save nearly $35 each month,

Drawbacks: By extending the length of the mortgage, the borrower increases the amount of interest paid over the life of the loan. On that $300,000 mortgage, it would mean an additional $170,030.42.

Negative Amortization Mortgage. This interest-only product allows buyers to pay less than the full amount of interest necessary to cover the costs of the mortgage. The difference between the full amount and the amount paid each month is added to the balance of the loan. This loan is best for borrowers with large cash reserves who want the flexibility of lower payments during certain parts of the year but plan to pay off loans in large chunks during other parts.

Benefits: An even smaller monthly payment than an interest-only mortgage in the first few years.

Drawbacks: Should housing prices stagnate or fall, buyers would find themselves in "negative equity," meaning they would owe money to the lender if they sold their homes.

Flex-ARM Mortgage. Each month the lender sends the borrower a payment coupon that calculates four payment options: negative amortization, interest only, 30-year fixed and 20-year fixed. The homeowner decides how much to pay. (Some mortgages offer only an interest-only and a 30-year-fixed option.) This structure is recommended for people who like options and have large cash reserves for when payments increase in the later portion of the loan.

Benefits: The bank does all the thinking. Each month it recalculates the balance and tells the borrower how much he or she would owe under different scenarios.

Drawbacks: Borrowers could end up owing more on the mortgage than they can fetch for their homes.

Piggyback Mortgage. This is really two mortgages, also known as a combo loan. The first covers 80% of the property's value. The second, with a slightly higher rate, covers the remaining balance. Young professionals with high salaries but little savings would benefit most from this loan type.

Benefits: In most cases, homeowners save money since the second loan allows them to avoid paying costly private-mortgage insurance when buying a home with less than a 20% down payment.

Drawbacks: Rates on the second mortgage are higher. And rates can vary greatly depending on credit scores. Also, since the borrower has little equity in the home, should its value fall when it is time to sell, the borrower would need to pay the difference in cash.

103s and l07s. These loans have no down payment and allow people to borrow 3% to 7% more than the house is worth. They are best for people with large cash reserves who prefer to invest in, say, the stock market rather than tying up assets in real estate.

Benefits: Minimal up-front costs.

Drawbacks: Rates tend to be high. And borrowers run the risk of negative equity if the house loses value.

Interest-Only. In the first 3 to 10 years, your payments cover only interest, not principal.

Benefits: This is right for you if you plan to move before the term ends, or you can count on earning more soon.

Drawbacks: When the interest term is up, your payments could increase so much that you can't afford your mortgage.

No-doc or low-doc Loan. This loan lets you borrow without proving you meet the usual income requirements and, in some cases, without documenting your income at all. Most lenders expect you to have a credit score of 620.

Benefits: This is right for if you don’t earn enough to qualify for a normal loan (for example, you are starting a business), but you know you won’t have trouble making the mortgage payments.

Drawbacks: Borrowing more than you afford. The rate may be higher than an equivalent full-doc loan.

A POINT ABOUT POINTS

As important as knowing interest rates is, knowing the lender's policies about the other key elements of a loan. What's tough on buyers is if they have a 90-day lock-in, and they lock in the rate and the points, say, two points. You have to tell them it's a gamble. They can save some money or lose some in a volatile market. It makes a difference whether they float with the points or lock them in. If you make buyers aware of points at the outset of their mortgage search, it helps them prepare. What you get for a dollar with points is a determining factor.

Points and closing costs can raise the true cost of a loan significantly. These fees assume a variety of names: fees for recording of mortgage, lender's inspection fee, lender's points, and prepaid interest. If you prepare buyers for such fees and familiarize them with their purpose, they can be better shoppers and find out for themselves, the true cost of a loan--the actual *annual percentage rate (APR).*

THE LOAN APPLICATION

Once you've discussed loan types with the buyers and given them the data they need to find financing, you should follow up to keep the loan process moving.

Guiding the buyers through the loan application process is easy if you've prequalified them properly. Loan applications themselves are no big deal.

Providing the basic personal information takes little of the buyers' time; amassing the financial data and credit history is what takes time and maybe some help from you as well. A typical loan application asks for employer, earnings, bank accounts and investments, debts (such as installment debts, charge accounts, auto loans, and alimony), and credit history.

The application process is now easier. For instance, lenders are more willing to accept paycheck stubs from the borrower as evidence of income instead of a written letter from the employer, along with W2 forms for the past two years to verify income stability. They're also more willing to accept a photocopy of a savings account statement instead of a letter from the buyer's bank. With this kind of documentation and photocopies of mortgage payments for 12 months of canceled checks for 6 months of rent payments, some lenders will now issue an approval within two weeks. The approval is contingent on an acceptable appraisal establishing value and on an acceptable source of down payment and closing costs.

Quick-approval loans that promise 15-day processing from application to approval are more common when lenders are competing for business. The salesperson can help buyers link up with a good lender. At this point, the application is in the lender's hands. But even so, you should be ready to follow up with the buyer and the lender to help ensure that a qualified buyer perseveres through the loan application process.

WATCH THE FINANCE SCENE

Your assistance during the long wait between choosing a home and getting a loan can help close the sale. Remember, you're the link between the lender and the buyer. Keep in touch with the lender and alert the buyer to any missing documents or problems. You can also reassure the buyer who's unnecessarily anxious about loan approval. Working closely with a good lender is the key to successful financing. That's not all there is to a mortgage loan, however. Credit reports and appraisals are also crucial to the process, and you'll need to work just as closely with allied professionals in those fields. But if you keep pace with the financial side of real estate, you'll be a step ahead of the game.

FOLLOW UP THE LOAN PROCESS

Both the lender and the buyer could use your support while the loan is being processed. But what responsibilities do you and the lender have toward each other and to the buyer? Communication with all parties and paying attention to details can speed up the transaction--and that commission check.

CONTACT WITH THE LENDER

It makes sense to maintain contact with the lender to see how things are coming along. It's helpful, though, to know just whom you should contact. Usually a loan processor and a loan officer handle the loan. There's a difference between the two, though in smaller loan departments that person might be one and the same. The loan officer prequalified the buyer, selects the loan most appropriate for the buyer, and is your main contact person.

The processor takes all the needed documentation (employment verification, account numbers of bank accounts, credit report, tax forms, and so on) and packages the loan so that it meets the requirements of the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). The processor obtains the lender's stacking order and also orders the appraisal and title report.

The loan then goes to the loan officer, who'll keep you abreast of new developments regarding the transaction and let you know whether there's anything you can do to assist in the process. The loan is subsequently sent to the underwriter or a loan committee or both for review and final approval. It's a process of check and double-check.

How often should you check in with the loan officer? That probably depends on your relationship. Communication is crucial between the real estate professional and the lender. Communication lines should be open during the follow-up.

INFORM THE BUYER

What about contact with the buyers? Salespeople should let buyers know what they can do to expedite the loan process: "If verifications get hung up somewhere, a buyer might have better luck calling and working his way through the system."

What else can a real estate professional do to help the process along? Check for earnest money funds, inform buyers about homeowner's insurance, and order a profile of the property. A salesperson can help out with the appraisal as well by obtaining comparables for the appraiser. The availability of appraisals of like-kind property makes the appraiser's job easier. However, some appraisers want the help of a real estate professional but others don't, so it's a good idea to check with the appraiser involved.

LOAN REJECTION OR ACCEPTANCE

If a loan is rejected, there is some recourse for a real estate professional. You can try to help identify the problem (poor credit and employment problems, for instance) and be realistic and supportive. When a buyer's loan is rejected, you might want to tell the buyer, "This particular loan company rejected the loan. But there's latitude within the Fannie Mae and Freddie Mac rules and regulations. Even though one company disapproved the loan, it doesn't mean another won't approve you. It's a race to the finish line, and just because we stumbled, it doesn't mean we should give up. When a loan is accepted, you should let buyers know about closing costs before closing.

Communication is of utmost importance during the follow-up process. Your role as communicator and facilitator is more important than ever. You'll increase your professionalism and your reputation with lenders and buyers alike by being thorough and accurate.

FUNDAMENTALS OF INVESTING

GETTING STARTED AS AN INVESTOR

Before you invest any funds, you should evaluate your present financial condition. Consider your income, expenses, taxes, future prospects for higher earnings, and all other details that affect your monetary situation. Decide how much you want to invest. Realistically, it can be done only with money left over after paying expenses, having proper insurance, and making pension contributions.

Then very carefully formulate your investment goal or goals. Will you invest in order to earn a profit? As a hedge against economic fluctuations such as inflation to build up a retirement income? Your next step should be to examine the investment choices presented in this column and then decide which kinds of investments are best for you.

You should attempt to formulate an investment strategy based on your goals and financial characteristics. Investment planning should be aimed at arriving at a good mix of risk and reward. You should take into account the types of investments available including their return potential and riskiness. Also, You should be aware of the general risks of investing including those related stock market price variability, inflation, and money market conditions.

Set your long-term goals first, thinking in terms of the middle and distant future. Then establish short-term financial objectives that are consistent with the long-term aims. After six months or a year, if you haven't been able to meet your short-term goals, you may have to reevaluate the long-term objectives. If, however, you have done much better than you expected to do, you may want to formulate more ambitious goals. Keep in mind that investing is an integral part of your overall financial planning.

SOURCES OF MONEY FOR INVESTING

If possible, try to invest 15% of after-tax income. Also, make sure before starting to invest in securities such as stock, your total assets should be two times your liabilities. Below are the possible sources of money available for investing.

- Discretionary income. After-tax income is disposable income, money available to you for spending or saving. You must commit much of your disposable income to fixed or semi-fixed expenditures such as housing cost, food, and transportation. Discretionary income is what is left after these expenses.
- Home equity. You may have a substantial amount of money sitting on your home. You can cash out some of it via either a home equity loan or equity line.
- Life insurance. If you have a cash value (e.g., whole-life or variable life) life insurance, you can borrow up to a certain amount.
- Profit sharing and pension. If you own some form of annuity, again you may borrow up to a certain amount at a low interest.

- Gift from your parent or rich uncle.
- OPM (other people's money).

FACTORS TO BE CONSIDERED IN INVESTMENT DECISIONS
Consideration should be given to safety, return and risk, stability of income, and marketability and liquidity.

Security of principal. It is the degree of risk involved in a particular investment. You will not want to lose part or all of the initial investment.

Return and risk. The primary purpose of investing is to earn a return on your money in the form of: interest, dividends, rental income, and capital appreciation. However, increasing total returns would entail greater investment risks. Thus, yield and degree of risk are directly related. Greater risk also means sacrificing security of principal. Remember: You have to choose the priority that fits your financial circumstances and objectives.

Stability of income. When a steady income is a most important consideration, bond interest or stock dividends should be emphasized. This might be the situation if you need to supplement your earned income on a regular basis with income from your outside investment.

Marketability and liquidity. It is the ability to find a ready market to dispose of the investment at the right price.

Tax Factors. Investors in high tax brackets will have different investment objectives than those in lower brackets. If you are in a high tax bracket, you may prefer municipal bonds (interest is not taxable), real estate (with its depreciation and interest write-off), or investments that provide tax credits or tax shelters, such as those in oil and gas.

In addition, there are many other factors to be considered, including:

- Current and future income needs
- Hedging against inflation
- Ability to withstand financial losses
- Ease of management
- Amount of investment
- Diversification
- Taxes and estate status
- Long-term versus short-term potential
- Denominations of investments required (For example, some real estate investment trusts (REITs) require a $5,000 minimum investment)
- Need for collateral for loans

- Protection from credit claims

QUESTIONS TO BE ASKED

In developing your investment strategy, it will be advisable to ask the following questions:

- What proportions of funds do you want safe and liquid
- Are you willing to invest for higher return but greater risk
- How long of a maturity period are you willing to take on your investment?
- What should be the mix of your investments for diversification (e.g., stocks, gold, real estate)?
- Do you need to invest in tax-free securities?

TYPES OF INVESTMENTS

Investments can be classified into two forms: fixed-income and variable-income. Simply stated, fixed-income investments promise you a stated amount of income periodically. These include corporate bonds and preferred stocks, U.S. government securities (Treasury bills), municipal bonds, and other savings instruments (savings account, certificate of deposit). On the other hand, variable-dollar investments are those where neither the principal nor the income is contractually set in advance in terms of dollars. That is, both the value and income of variable-income investments can change in dollar amount, either up or down, with changes in internal or external economic conditions. These include common stocks, mutual funds, real estate, and variable annuities.

Investments can be viewed as financial or real assets. Financial assets comprise all intangible investments--things you cannot touch or wear or walk on. They represent your equity ownership of a company, or they provide evidence that someone owes you a debt, or they show your right to buy or sell your ownership interest at a later date. Financial assets include:

1. Equity claims - direct

   - Common stock
   - Options and warrants

2. Equity claims - indirect
   - Mutual funds

3. Creditor claims

   - Savings accounts and certificates of deposit (CDs)
   - Treasury bills
   - Money market funds

- Commercial paper
- Corporate and government bonds

4. Preferred stock
5. Commodities and financial futures
6. Annuities

Real assets are those investments you can put your hands on. Real assets include:

- Real estate
- Precious metals
- Collectibles and gems

An investment may be short-term or long-term. Short-term investments are held for one year or less, while long-term investments mature after more than one year. An example of a short-term investment is a treasury bill. A Treasury bill is a short-term U.S. government obligation that is sold at a discount from its face value. A Treasury bill is highly liquid and nearly risk-free, and it is often held as a substitute for cash. A typical long-term investment is a ten-year bond. Some long-term investments have no maturity date. Examples of along-term investment are equity securities such as common stock and preferred stock. But you can purchase a long-term investment and treat it as a short-term investment by selling it within a year. *Note*: In selecting the types of investments you would want, be cautious in taking salespeople's (e.g., brokers, mutual fund representatives) advice because their prime motivation is to earn a commission. Consult instead financial planners, CPAs, or investment advisors.

COMMON STCKS, PREFERRED STOCKS, AND BONDS

Common stock is a security that represents an ownership interest in a corporation. This ownership interest is evidenced by a transferable stock certificate. Each share is a fractional ownership interest in a corporation. You acquire an equity interest in the corporation by buying its stock. As a stockholder, you can vote for the board of directors of the corporation. The equity investment has no maturity date. Preferred stockholders have preference over common stockholders with respect to dividend and liquidation rights, but payment of preferred dividends, unlike bond interest is not mandatory. In exchange for these preferences, the preferred stockholders give up the right to vote.

A bond is a certificate evidencing a loan by you to a business or to government. You will receive interest and principle repayment for your investment. Bonds may be categorized as follows:

(a) Mortgage bonds. Mortgage bonds are secured with specific fixed assets, usually real property. Thus, under the rights enumerated in the bond indenture, creditors will be able to receive payments from liquidation of the property in case of default.

(b) Debentures. They are backed by the issuing corporation's good faith and credit. The issuing company must be financially sound. High credit ratings are essential. Government bonds are examples.

(c) Subordinated debentures, honored after debentures in the case of liquidation or reorganization (though still before stocks). Junior debentures are sometimes issued by finance companies.

(d) Income bonds. The bonds pay interest only if there is profit.

RISK, RETURN AND INVESTMENT POLICY

How much financial risk should you be willing to take on an investment? Risk is the chance you take of losing money on an investment; it is the uncertainty regarding the investment's final payoff, in other words. The more an investment can vary in value during the maturity period, the greater the risk you take when you buy and hold on to it.

All investments involve some degree of risk. In general, you will have to find a balance between risk and return; the higher the risk, the greater must be the return. Aggressive investment policies attempt to maximize return and take above-average risk. Defensive investment policies are designed to reduce risk but also provide less return. If you invest aggressively, you tend to buy and sell more frequently. In a defensive strategy, there is a "buy and hold" philosophy. Aggressive investment may include buying securities on margin (credit) so as to increase profit potential. Defensive investment does not rely on credit (or leverage). Diversification is a defensive policy.

Aggressive investing involves concentration by investing in a few securities at one time in anticipation of a high return. Often, the more money you invest in one source, the higher the rate of return. For example, a bank will usually pay you a higher interest rate on a $100,000 investment compared to a $10,000 investment.

Most investors favor safe investments over risky ones. If you are one of them who wants a safe investment with predictable but low return, invest in U.S. government securities (e.g., Treasury bills), bank account, or money market mutual fund. If you are retired, you may favor safe investments providing fixed yearly returns. Appreciation in the price of a security is not as important as stable, guaranteed income. Risky investments are undesirable due to uncertainty. Thus, a retiree may be satisfied with a long-term government bond.

MARKETABILITY AND LIQUIDITY

Marketability should be distinguished from liquidity. Marketability means you can find a ready market if you want to sell the investment. Liquidity means the investment is not only marketable but also has a highly stable price.

Liquidity may be important if you have limited investments or are saving for a specific personal or business item (e.g., down payment on a house). However, liquid investments typically earn less of a return than illiquid ones. You desire to minimize delays and transaction costs to convert the investment into immediate cash. Liquid investments include savings accounts, money market funds, and certificates of deposit. If you may need funds in an emergency, liquid fund should exist!

The following table depicts marketability and liquidity factors for an investment.

	Marketability	***Liquidity***
-Savings accounts	Not applicable	good
-Corporate bonds	Good	Average
-Short-term U.S. government securities	Good	Good
-Long-term U.S. government securities	Good	Average
-Common stock	Good	Poor
-Real estate	Average	Poor

HOW INTEREST RATES AFFECT YOUR INVESTMENT?
Bonds are sensitive to changes in interest rates. When interest rates go up, bond prices go down. If you paid $1,000 (par) for a bond that paid 6%, or $60 interest per year, and then interest rates went up so that newly issued bonds were paying 8%, or $80 interest, no one would want to buy your bond for $1,000. Why would anyone take 6% if that person could get 8%? The price of your bond would have to decline so someone could buy it at a discount (below $1,000), so he or she could make a profit on the lower price paid and get back $1,000 at maturity.

As interest rates increase, stock prices also tend to decrease for the following reasons:

- Dividends are less attractive. Thus, there tends to be a sale of stocks.
- It makes it more costly to buy stock on margin (credit) discouraging investment in stocks.
- It results in higher cost to business of financing, decreasing profits and inhibiting expansion.

Real estate is pretty sensitive to mortgage rate changes. sensitive to interest rate changes.

HOW WOULD INFLATION AFFECT YOUR INVESTMENT?
Inflation is an increase in price for goods and services over a short time period. A rapid increase in inflation will cause interest rates to rise, and bond and stock prices to fall. *Recommendation:*

Avoid fixed income securities. Consider buying real assets such as real estate since they are generally considered inflation hedgers. Investments doing well or poorly in inflation are given below.

INVESTMENT PERFORMANCE IN INFLATION

Good Performance in Inflation:

Real estate
Precious metals (gold and silver)
Collectibles
Mutual funds specializing in mining stocks

Bad Performance in Inflation:

Bonds
Short-term securities (T-bills and CDs)
Mortgage-backed securities

WHAT ARE SOME INVESTMENT GUIDELINES TO FOLLOW?
Investment tips follow:

-If you want to speculate do it in stock where the gains can be significant, not in corporate bonds.
-You are better off buying a high quality bond issue.
-Purchase stocks when they are undervalued and hold for the long-term.
-Do not invest in a tax shelter unless it appears to be a good investment.
-Do not invest too heavily in precious metals because of volatility.
-Buy into a mutual fund that shows a consistent long-term performance (e.g., five or ten year period) and did well in both good and bad markets. A mutual fund may show great performance only in one year because of luck, unusual circumstances, or the risky stocks bought shot up.

Warning: Avoid selling short, buying options, and investing in commodities because these are short-term, risky investment strategies and if you are wrong on timing and market direction, you may suffer significant losses.

-Buy real estate in a good location and hold for 5-7 years.

IS IT WORTH BORROWING MONEY TO INVEST?
You may want borrow money to make investments. This is known as leverage. You can drastically increase the yield on an investment otherwise made entirely from your own funds.

This increase occurs when the return on investment exceeds the cost of borrowing. You can achieve maximum return:

-By buying stocks on margin
-Through options or futures contracts
-By putting down as little money as possible (or sometimes no money down) in real estate.

UNDERSTANDING RETURN AND RISK

To be successful as an investor, you need an understanding of investment risk and realistic expectations of reward. Also, an understanding of the tradeoff between the return you are expecting from an investment and the degree of risk you must assume to earn it is perhaps the most important key to successful investing. This section discusses:

-Return and how it is measured.
-Types of risk and how to reduce risk.
-Investment alternatives and their relationship to risk.

WHAT IS RETURN?

Return is a key consideration in the investment decision. It is the reward for investing. You must compare the expected return for a given investment with the risk involved. The return on an investment consists of the following sources of income:

(a) Periodic cash payments, called current income.
(b) Appreciation (or depreciation) in market value, called capital gains (or losses).

Current income, which is received on a periodic basis, may take the form of interest, dividends, rent, and the like. Capital gains or losses represent changes in market value. A capital gain is the amount by which the proceeds from the sale of an investment exceeds its original purchase price. If the investment is sold for less than its purchase price, then the difference is a capital loss.

The way you measure the return on a given investment depends primarily on how you define the relevant period over which you hold the investment, called the holding period. We use the term holding period return (HPR), which is the total return earned from holding an investment for that period of time. It is computed as follows:

$$\text{HPR} = \frac{\text{Current Income} + \text{Capital Gain (or loss)}}{\text{Purchase Price}}$$

EXAMPLE 1

Consider the investment in stocks A and B over a one period of ownership:

	Stock	
	A	B
Purchase price (beginning of year)	\$100	\$100
Cash dividend received (during the year)	\$13	\$18
Sales price (end of year)	\$107	\$97

The current income from the investment in stocks A and B over the one-year period are \$13 and \$18, respectively. For stock A, a capital gain of \$7 (\$107 sales price - \$100 purchase price) is realized over the period. In the case of stock B, a \$3 capital loss (\$97 sales price - \$100 purchase price) results.

Combining the capital gain return (or loss) with the current income, the total return on each investment is summarized below:

	Stock	
Return	A	B
Cash dividend	\$13	\$18
Capital gain (loss)	7	(3)
Total return	\$20	\$15

Thus, the return on investments A and B are:

$$\text{HPR (stock A)} = \frac{\$13 + (\$107 - \$100)}{\$100} = \frac{\$13 + \$7}{\$100} = \frac{\$20}{\$100} = 20\%$$

$$\text{HPR (stock B)} = \frac{\$18 + (\$97 - \$100)}{\$100} = \frac{\$18 - \$3}{\$100} = \frac{\$15}{\$100} = 15\%$$

Table 1 shows the rates of return in ranking order by type of investment for the period 1997-2006.

Table 1 Rates of Return in Ranking Order
1997-2006

Rank	Investment
1	Real Estate

2	Metals
3	Portfolios
4	Stocks
5	T-bills
6	Bonds

RISK AND THE RISK-RETURN TRADE-OFF
Risk refers to the variability of possible returns associated with a given investment. Risk, along with the return, is a major consideration in investment decisions. The investor must compare the expected return from a given investment with the risk associated with it. Higher levels of return are required to compensate for increased levels of risk. In general, there is a wide belief in the risk-return trade-off. In other words, the higher the risk undertaken, the more ample the return, and conversely, the lower the risk, the more modest the return.

WHAT ARE THE TYPES OF RISK?
Risk refers to the variation in earnings. It includes the chance of losing money on an investment. There are different types of risk. These risks affect various investment alternatives, such as stocks, bonds, or real estate, differently. All investments are subject to risk.

1. Business risk. Business risk is the risk that the company will have general business problems. It depends on changes in demand, input prices, and obsolescence due to technological advances.
2. Liquidity risk. It represents the possibility that an asset may not be sold on short notice for its market value. If an investment must be sold at a high discount, then it is said to have a substantial amount of liquidity risk.
3. Default risk. It is the risk that the issuing company is unable to make interest payments or principal repayments on debt. For example, there is a great amount of default risk inherent in the bonds of a company experiencing financial difficulty. The marketable securities with the lowest default risk are those issued by the federal government because they are backed by the full faith and credit of the U.S.
4. Market risk. Prices of all stocks are correlated to some degree with broad swings in the stock market. Market risk refers to changes in the price of a stock that result from changes in the stock market as a whole, regardless of the fundamental change in a firm's earnings power. For example, the prices of many stocks are affected by trends such as bull or bear markets.
5. Interest rate risk. It refers to the fluctuations in the value of an asset as the interest rates and conditions of the money and capital markets change. Interest rate risk relates to fixed income securities such as bonds and real estate. For example, if interest rates rise (fall), bond prices fall (rise).

6. Purchasing power risk. This risk relates to the possibility that you will receive a lesser amount of purchasing power than was originally invested. Bonds are most affected by this risk since the issuer will be paying back in cheaper dollars during an inflationary period.
7. Systematic risk. The relevant risk of a security is its contribution to the portfolio's risk. Systematic risk is the risk that cannot be eliminated through diversification. The relevant risk results from factors, such as recession, inflation, and high interest rates that affect all stocks.

HOUSING: THE COST OF SHELTER

Homeownership is perhaps the most sizable investment you will ever make in your life. Further, your home is a tax shelter. There are many questions surrounding homeownership. In this chapter, you will find the answers to the following important questions:

- Should you buy or rent?
- How to price a home?
- How much can you afford to pay for a house?
- How to shop for an adjustable rate mortgage?
- Should you refinance your home?
- Should you payoff your mortgage early?
- How good is your homeowners' policy?
- How to get top dollar for your house?
- How to sell your home yourself?

SHOULD YOU BUY A HOME OR RENT?

For many people, the decision to buy a home is more emotional than economic. But if you are wondering about whether or not to go on renting, here are some questions to help you answer when renting is right:

- Do you have enough money to put down to buy a home? The initial cost of home ownership can be substantial. For example, for a $100,000 house you should figure on having anywhere between $10,000 to $20,000 (10% to 20%) for the down payment, $3,000 to $6,000 (3% to 6%) for closing costs and a $2,000 cushion for contingencies. Thus, at the time of purchase you will need to pay cash of anywhere between $15,000 and $28,000.
- Are you the roving kind? If you stand a good chance of being relocated in a few years it doesn't make sense to buy because of high borrowing, closing, and commission costs.
- Do you live in an area where renting makes sense? In regions where there is a housing glut and rent controls and values are flat or falling, renting ends up being a bargain.

- Are you lazy or a born renter? Can you deal with maintenance and lawn mowing? Or would you rather leave it up to a landlord by renting? Are you enjoying the appeal of community living and access to amenities such as swimming pools and tennis courts?

The disadvantages of renting are primarily financial and economic. Owning a home is still the best tax-shelter there is. The renter does not receive any federal tax-deductible benefit from rent payments. Also, the rent payment does not contribute to building your equity, You are at the mercy of rent increases and the landlord.

Homeownership has the following advantages:

- You are building equity due to the appreciation in the value of the home.
- Interest and property taxes are deductible on the tax return.
- Usually less costly than renting.
- You may enjoy extra living space and privacy.
- Single-family homes are usually in better locations than apartments.
- You will have a sense of stability and roots in the community.
- You will enjoy pride of ownership.

Note: The disadvantages of homeownership tend to be the advantages of renting and vice-versa.

In comparing rental and purchase costs, the worksheet in Table 2 can be useful:

TABLE 2
COMPARISON OF RENTAL AND PURCHASE COSTS

Rental Cost	
Annual rental cost ($850 x 12)	$10,200
Purchase Costs (assuming a 30% tax bracket):	
Add:	
Mortgage Payment ($100,000 @ 10%, 30 years	10,608
Principal = $608 (approximate)	
Interest = $10,000 (approximate)	
Property Taxes	1,300
Property Insurance	250
Maintenance	400
Cost of lost interest on $20,000 @ 5% (after-tax rate of return)	1,000
Subtract:	
Principal reduction in loan balance	(608)
Tax savings due to mortgage interest deduction ($10,000 * .3)	(3,000)
Tax savings due to property tax deduction ($1,300 * .3)	(390)
Net annual after-tax purchase costs	$9,560

Annual Benefit of Buying $640*

*Note that the annual benefit does not include appreciation in the value of your home.

WHAT PRICE TO PAY?

After you found the house you like, you must decide what price to pay for it. In most cases, there is room between the price sellers ask and the price that they are willing to accept. Make sure that you are not paying more for a property than its market value. To determine the maximum price to pay for the property is not an easy task. Two methods are widely used in practice.

-Have your real estate agent run "comparative-sales" on a computer.

The computer should be able to give you recent history of sales in the neighborhood. The price that a subject property can bring must be adjusted upward or downward to reflect the difference between the subject property and comparables. Since this particular approach is based on selling price, not asking prices, it can give you a good idea about the market.

-Use an expert. You might want to hire a professional real estate appraiser for a fee.

Appraisal is not a science, but a complex and subjective procedure that requires good information about specific properties, their selling prices, and applicable terms of financing. The use of an expert may well be worth the cost if you worry about the possibility of paying too much.

HOW MUCH CAN YOU AFFORD TO SPEND FOR HOUSING?

An accurate way to determine what kind of house you can afford is to make two basic calculations: How much can you pay each month for the long-term expenses of owning a home (e.g., mortgage payments, maintenance and operating expenses, insurance and property taxes)? And, how much cash do you have to spend for the initial costs of the purchase (e.g., the down payment, points and closing costs)?

Many lenders use various rules of thumb to determine a borrower's housing affordability.

They include:

-35-Percent Rule of Thumb. A borrower can afford no more than 35 percent of monthly take-home pay.

EXAMPLE 1

Your gross annual income is $33,000 per year and take-home pay is $2,095 per month. At 35 percent, you could afford a monthly payment of $733. Using this amount, the mortgage rate (variable or fixed), the mortgage term, and a mortgage payment schedule, the lender can determine how much you can qualify for. For example, say, an interest rate of 13 percent and a 30-year term, you could borrow $66,300. Assume that your budget has already provided for property taxes, insurance, and maintenance expenses and you have $20,000 available for a down payment (after point charges and closing costs). You could buy a house that costs about $86,300 ($20,000 + the $66,300 mortgage.)

-Multiple of Gross Earnings Rule. The price should not exceed roughly 2 to 2 1/2 times your family's gross annual income.

EXAMPLE 2

If your annual gross income is $40,000, the maximum price you could afford would be $80,000 (2 x $40,000) to $100,000 (2.5 x $40,000).

-Percent of Monthly Gross Income Rule. Your monthly mortgage payment, property taxes and insurance should not exceed 25% to 28% of your family's monthly gross income, or about 35% for an Federal Housing Administration (FHA) or Veterans Administration (VA) mortgage.

EXAMPLE 3

You and your spouse have gross income of $60,000 ($5,000 a month). Under this rule, your monthly mortgage payment, property taxes and insurance should not exceed $1,250 (25% of $5,000) to $1,400 (28% of $5,000). That means you could qualify for a 30-year fixed rate loan (with 10-20% down) at less than a 12% rate.

-Your debt payments on loans of 10 months or longer, including your mortgage, should not exceed 36% of your gross income, 50% for an FHA or VA loan.

EXAMPLE 4

You and your spouse have gross income of $60,000 ($5,000 a month). If you have a monthly debt load of $500 or less, you might look for a $120,000 house with total monthly housing payments of about $1,300, since total debt payments of $1,800 ($1,300 + $500) equals or is close to 36% of $5,000 monthly gross income). That means you could most likely qualify for a 30-year fixed rate loan (with 10-20% down) even if rates hit 12%.

DOES IT PAY TO REFINANCE YOUR HOUSE?

Whether refinancing is worthwhile depends on the costs of refinancing and the time required to recoup those costs through low mortgage payments. The costs of refinancing are the closing costs, which can vary widely. Closing costs include:

.Title search
.Insurance (such as hazard, title, and private mortgage insurances)
.Lender's review fees

.Buyer's loan points
.Re-appraisal fees
.Credit report
.Escrow fees
.Lawyer fees
.Document preparation fees, judgment reports, notary fees, and recording fees

To get a rough estimate of the closing costs, take the costs of refinancing (3 to 6 percent of the outstanding principal) and multiply it by the amount of the loan.

EXAMPLE 5
If the loan amount is $100,000 and the cost is, say, 5 percent, the closing costs are $5,000.

Rule of thumb: To refinance successfully, you should plan on staying in the house for at least three years and should be able to reduce the rate paid on the mortgage by at least two percentage points.

-If you are a fixed-rate mortgage holder, you might look for another fixed-rate home loan at least two to three percentage points below the mortgage currently held.
-If you have an adjustable loan, you might consider what the expected rate on the adjustable rate mortgage (ARM) will be several years hence. If the current rates on fixed mortgages are substantially below the expected rate on the ARM, it might pay to refinance.

Rule of thumb: The factor to consider when refinancing is the amount of time it will take to recoup the costs of refinancing.

EXAMPLE 6
Assume that refinancing is $75,000. A 14 percent mortgage involves closing fees of $3,750, and the new interest rate is 10 percent. At the new rate of 10 percent, the monthly payment on a 30-year fixed loan would be $658. That is a savings of $231 from the monthly payment of $889 required on a 14 percent loan. Dividing the total refinancing cost of $3,750 by $231 gives a recovery period of about 16 months. Table 3 below illustrates the monthly and yearly savings from refinancing to a 10 percent 30-year fixed-rate mortgage for $75,000.

TABLE 3
SAVINGS FROM REFINANCING

Present Mortgage Rate	*Current Monthly Payment*	*Monthly Payment @ 10%*	*Monthly Savings @ 10%*	*Annual Savings @ 10%*
12.0%	$771	$658	$113	$1,356
12.5	800	658	142	1,704

13.0	830	658	172	2,064
13.5	859	658	201	2,412
14.0	889	658	231	2,772
15.0	948	658	290	3,480

HOW TO SHOP FOR AN ADJUSTABLE RATE MORTGAGE?
An ARM is a mortgage where the interest rate is not fixed but changes over the life of the loan. ARMs are often called variable or flexible rate mortgages.

Adjustable rate mortgage (ARM) often feature attractive starting interest rates and monthly payments. But you face the risk that your payments will rise. Pluses of ARMs include:

-You pay lower initial interest (often 2 or 3 percentage points below that of a fixed rate) and lower initial payments, which can mean considerable savings. This means that ARMs are easier to qualify for.
-Payments come down if interest rates fall.
-Loans are more readily available and their processing time is quicker than fixed-rate mortgages.
-Many adjustables are assumable by a borrower, which can help when it comes time to sell.
-Many ARMs allow you to prepay the loan without penalty.

Some of the pitfalls of ARMs include:

-Monthly payments can go up if interest rates rise.
-Negative amortization can occur. Note: Negative amortization occurs when the monthly payments do not cover all of the interest cost. The interest cost that is not covered is added to the unpaid principal balance. This means after making many payments you could owe more than you did at the beginning of the loan balance.
-The initial interest rates last only until the first adjustment, typically six months or one year. And the promotional or tease rate is often not distinguished from the true contract rate, which is based on the index to which the loan is tied.

Tip: It pays to get an ARM if you are buying a starter home or expect to move or be transferred in two to three years.

Recommendation: You should consider a fixed rate loan over an ARM if you
-Plan to be in the same home for a long time.
-Do not expect your income to rise.
-Plan to take sizable debts, like auto or educational loans.
-Prize the security of constant payments.

When you shop for an ARM (or for any other adjustable rate loan), you should carry the following checklist of questions to ask lenders:

-What is the initial loan rate and the annual percentage rate (APR)? What costs besides interest does the APR reflect? What are the points?
-What is the monthly payment?
-What index is the loan tied to? How has the index moved in the past? Will the rate always move with the index?
-What is the lender's margin above the index? Tip: The margin is an important consideration when comparing ARM loans, because it never changes during the life of the loan. Remember: Index rate + margin = ARM interest rate.

EXAMPLE 7

You are comparing ARMs offered by two different lenders. Both ARMs are for 30 years and amount to $65,000. Both lenders use the one-year Treasury index, which is 10%. But Lender A uses a 2% margin, and Lender B uses a 3% margin. Here is how the difference in margin would affect your initial monthly payment:

	Lender A	*Lender B*
ARM Interest Rate	12%(10% + 2%)	13%(10% + 3%)
Monthly Payment	$668.60 @ 12%	$719.03 @ 13%

-How long will the initial rate be in effect? Will there be an automatic increase at the first adjustment period, even if the index has not changed? What effect will this have on monthly payments?
-How often can the rate change?
-Is there a limit on each rate change and how will the limit affect monthly payments?
-What is the "cap," or ceiling on the rate change over the life of the loan?
-Does the loan require private mortgage insurance (PMI) and how much does it cost per month?
-Is negative amortization possible?
-Is the loan assumable?
-Is there prepayment penalty?

SHOULD YOU PAYOFF YOUR MORTGAGE EARLY?

Suppose you have decided to refinance your home with a lower fixed rate mortgage. You should consider the term of the loan. Although the standard 30-year mortgage is still very much alive and well, you might want to consider the loan with a shorter term such as a 15-year fixed rate loan. The overall savings in interest paid to the lender over the life of the 15-year mortgage can be quite substantial, yet the monthly payment is not significantly higher. Recommendation: Even if you decide to stay with your current 30-year mortgage, you might be able to save a bundle by paying off more in each month, treating the 30-year loan as if it were a 15-year loan.

EXAMPLE 8

Suppose you currently have a $100,000 30-year fixed rate mortgage at 13 percent. Your monthly payment for principal and interest is $1,106.20. You have decided to refinance your home with a fixed-rate loan at 10 percent. You have two options available: 30-year loan at 10 percent vs. 15-year loan at the same rate. Look at Table 4 for comparison regarding monthly payment and total interest over the life of the loan. Note: In either case, the monthly payment is less than the 13 percent mortgage. Between 30-year and 15-year, however, the monthly payment increases about 22.45% while the savings in total interest payments over the life would be almost 57 percent. From this example, you learn some valuable lessons:

1. It was a good decision to refinance your home, since, in either case, you save in your monthly payments ($1,106.20 vs. $877.57 and$1,074.61). In this example, a 3 percent drop in the fixed rate made this possible.
2. You would be able to save $122,495 in total interest payments by election of a 15-year loan without increasing your monthly burden.
3. Among other things, you will be a 100 percent equity holder in your home within 15 years instead of 30 years.

TABLE 4
COMPARISON OF 30-YEAR VS. 15-YEAR FIXED RATE MORTGAGE

	30-Year	*15-Year*	*$ Increase (Decrease)*	*% Increase (Decrease)*
Principal	$100,000	$100,000	--	--
Rate	10%	10%	--	--
Monthly Payment	$877.57	$1,074.61	$197.04	22.45%
Total Interest	$215,925	$93,430	($122,495)	(56.73%)

INVESTING IN REAL ESTATE

Investing in real estate is considered an inflation hedge. Real estate investing still provides tax shelters to many investors. The advantages of homeownership as an investment was discussed in the previous chapter. In this chapter our primary concern is with real estate that is not your principal residence. Such real estate includes income-producing properties and pooling arrangements such as Real Estate Investment Trusts (REITs). In this chapter, you will learn about:

- Advantages and pitfalls of real estate investing.

- REITs as an attractive tax shelter.
- Determination of after-tax cash flow.
- How to value an income-producing property.
- How to use leverage and increase return.

INVESTING IN REAL ESTATE IS AN I.D.E.A.L. SITUATION

It has often been said that real estate is the I.D.E.A.L. investment. Each of the five letters in IDEAL stands for an advantage to real estate as an investment.

- "I" stands for interest deduction. The mortgage interest paid on the first and second residential homes are tax deductible. On the average, real estate is a good hedge against inflation because property values and the income from properties rise to keep pace with inflation. "I" could mean income. Successful real estate investments usually produce an income stream that typically increases over time.
- "D" stands for depreciation. The building on your land depreciates in book value each year and you can deduct this depreciation from your gross income. This is only true for investment property and not residential. This provides a tax shield.
- "E" is for equity buildup. You build equity through repayments of the principal or remaining balance of the loan(s) taken to purchase the property. This equity buildup is like money in the bank. As you amortize a mortgage, the value of your equity investment will steadily rise. In the case of income-producing property, this amortization could mean that your tenants help you build your estate.
- "A" is for appreciation. Your property value goes up every year, hopefully. Appreciation can result from inflation or increases in demand for property or improvement to the property . As the income potential is increases, the price that the property can command in the marketplace rises.
- "L" is for leverage. When you buy a house you make a down payment, say, 10 percent and you borrow the balance, say, 90 percent. You get the benefit of all 100 percent even though you put up only 10 percent of your own money. You can maximize return with other people's money (OPM). The use of mortgage and OPM means that you can use small amounts of cash to gain control of large investments and earn large returns on the cash invested. Besides I.D.E.A.L., you could add the following advantages of investing in real estate:
- Tax-free refinancing. Mortgage proceeds even from refinancing are not taxable income to you. Therefore, refinancing is a way to recover your cash investment and, in some cases, you profit tax free.
- Pride of ownership. You may find greater personal satisfaction in owning property than stock certificates.
- Investment and consumption. Certain types of real estate, such as land and vacation homes, can serve both as investments and as sources of pleasure through use.

WHAT ARE THE DISADVANTAGES WITH REAL ESTATE?

Real estate investing is not free from problems. Watch out for the following:

- High transaction costs, such as brokerage commissions and closing expenses. These costs eat up short-term profits. Warning: If you might need your money out in a hurry, do not invest in real estate.
- Negative cash flow with little down (too much leverage). In jargon, we call it an alligator.
- Balloon payment due. *Note*: The balloon payment is the unpaid balance of a mortgage loan that is paid off in a lump sum at the end of the loan term. This is typically a large amount. You may be unable to make the final payment, default the payment, and lose your property.
- Limited marketability. Lack of a central market or exchange to make real estate investments more liquid.
- Management headache, such as unreliable tenants, or otherwise high professional management fees.

WHAT TYPES OF REAL ESTATE INVESTMENTS ARE THERE?

Kinds of real estate you can invest include:

- Undeveloped land
- Residential rental property (e.g., single family houses for rental, and multi-unit apartments)
- Commercial property (e.g., office buildings, shopping centers, and industrial property)
- Real Estate Investment Trusts (REITs)

FACTORS TO BE CONSIDERED REGARDING A REAL ESTATE INVESTMENT

- Location
- Method of financing the purchase of the property
- Before-tax cash flow
- After-tax cash flow
- Vacancy rate for rental property
- Gain or loss for tax purposes
- Management problems

WHAT ARE REAL ESTATE INVESTMENT TRUSTS (REITS)?
Real estate investment trusts (REITs) are corporations that operate much like closed-end mutual funds explained previously, investing shareholders' money in diversified real estate or mortgage portfolios instead of stocks or bonds. Their shares trade on the major stock exchanges or over-the-counter.

By law, REITs must distribute 95 percent of their net earnings to shareholders, and in turn they are exempt from corporate taxes on income or gains.

HOW ABOUT REIT YIELDS?
Since REIT earnings are not taxed before they are distributed, you get a larger percentage of the profits than with stocks. REIT yields are high, ranging between 5 1/2 to 10 1/2 percent.

WHAT ARE THE TYPES OF REITS?
There are three types of REITs: Equity REITs invest primarily in income-producing properties; mortgage REITs lend funds to developers or builders; and hybrid REITs do both. Experts feel that equity REITs are the safest.

WHAT YOU SHOULD KNOW ABOUT REITS?

Pluses
- Dividend income with competitive yields
- Potential appreciation in price
- A liquid investment in an illiquid area
- Means of portfolio diversification and participation in a variety of real estate with minimal cash outlay

Minuses
- Possible glut in real estate or weakening demand
- Market risk: possible decline in share price

Safety
- High

Liquidity
- Very high: shares traded on major exchanges or over-the-counter and therefore sold at any time

Taxes
- Income subject to tax upon sale.

HOW SHOULD YOU SELECT A REIT?

Before buying any REIT, be sure to read the latest annual report, *The Value Line Investment Survey* , *Audit Investment's Newsletter*, or *Realty Stock Review*. For more on REITs, visit National Association of Real Estate Investment Trusts (www.nareit.com/mynareit.cfm). Check the following points.

- Track record: how long in business as well as solid dividend record
- Debt level: make sure that the unsecured debt level is low
- Cash flow: make sure that operating cash flow covers the dividend.
- Adequate diversification: beware of REITs investing in only one type of property
- Property location: beware of geographically depressed areas
- Type of property: nursing homes, some apartment buildings, shopping centers presently favored; "seasoned" properties preferred
- Aggressive management: avoid REITs that do not upgrade properties.
- Earnings: monitor earnings regularly; be prepared to sell when the market of property location weakens.

HOW DO YOU DETERMINE CASH FLOW FOR REAL ESTATE?

A necessary task in analyzing an income-producing property is determining the before-tax cash flow. When you know the cash flow, you can figure your return on your investment, calculate the tax shelter, and evaluate the investment, in other ways. You don't need to be a real estate expert to determine a property's cash flow, common sense and some uncomplicated research will provide you with a base figure.

EXAMPLE 1

John Smith recently calculated the cash flow of a property offered to him for investment. We will go through his analysis, step by step, as an example of the process and format which you can follow. Mr. Smith is considering a duplex apartment. The property is located in an attractive suburb. The cost of the building is $219,000 and a $175,000, 30-year mortgage at 12% fixed rate is anticipated. The projected figures are based on the first full year of operation.

Step 1. Figuring gross income

The building has two three-bedroom apartments. To judge how much the apartments could rent for, Mr. Smith compared his building to ones in the area which were similar in quality of location and construction. He studied advertisements and questioned area real estate brokers. After weighing this information, he decided the three-bedroom could rent for $950. Thus, the total maximum yearly rental income was $22,800.

2 x $950 = $1,900
$1,900 x 12 = $22,800

Additional income of $800 from laundry fees would make the possible total gross income $23,600.

Step 2 Vacancy and credit losses

To estimate the reduction in gross income caused by vacancies and bad debts, Mr. Smith looked at the result of the survey conducted by the local realtors and apartment associations. He estimated that the vacancy and bad debt rate would be 2% of possible gross income or $472 (2% of $23,600). Please refer to Table 5 (Annual Property Operating Data).

Step 3 Operating expenses

For estimates of operating expenses, Mr. Smith carefully examined the record of previous costs by category. He came up with the cost figures as shown in the chart, which are basically the previous costs plus adjustments for inflation.

Step 4 Net operating income

The projected operating expenses totaled $4,510 or 19.50% of gross operating income ($23,128). This left a net operating income (NOI) of $18,618 ($23,128 - $4,510). Now we proceed to calculating before-tax cash flow:

Step 5 Debt service (principal and interest payments)

Payments at 12% on a $175,000, 30-year fixed-rate mortgage would be $1800.08 per month or $21,601 annually (principal amount is $635)

Step 6 Before-tax cash flow

The estimated before-tax cash flow was ($2,983) on an investment of $44,000 ($219,000 - $175,000).

TABLE 1 ANNUAL PROPERTY OPERATING DATA (12 months – projected)				
	Gross Scheduled Income			$22,800
	+ Other Income			800
Total Gross Income				23,600
	- Vacancy/Credit Losses (2%)			472
Gross Operating Income (GOI)				23,128
Operating Expenses (with percent of GOI)				
	Property insurance	1.93%	$446	
	Real Estate Taxes	13.22%	3,058	
	Repairs and Maintenance	1.45%	335	
	Sewer and Water	2.90%	671	

Total Operating Expenses (19.50%)	4,510
Net Operating Income (80.50%)	18,618
- Debt Service (Principal and Interest)	21,601
Before-Tax Cash Flow	($2,983)

In order to compute after-tax cash flow, we have to add principal payments and deduct annual depreciation as follows:

Before-Tax Cash Flow	$(2,983)
Add: Principal	635
Less: Depreciation	5,575*
Taxable Income (loss)	$(7,923)
Your Income Tax Rate	* .35
Value of Taxable Loss	$2,773

*Assumption: The depreciable base of the building is 70% of $219,000=$153,300. Annual depreciation is therefore $5,575 ($153,300/27.5 years by straight line).

Then your after-tax cash flow is:

Before-Tax Cash Flow	$(2,983)
Add: Value of Taxable Loss	2,773
After-Tax Cash Flow	$(210)

Note: Due to the deductibility of interest payments and annual depreciation for income tax purposes, after-tax cash flow is reduced by a substantial amount (In this example, after-tax was only -$210 as compared to before-tax of -$2,983. Don't forget: We did not even take into account the potential appreciation of the property. The return on your investment in this building should be calculated on the basis of both annual after-tax cash flows and the selling price of the property at the end of the holding period.

HOW DO YOU VALUE AN INCOME PRODUCING PROPERTY?
There are several rule of thumb methods to arrive at the estimated value of an income-producing property. They include:

- Gross Income Multiplier. Gross income multiplier is calculated as: Purchase price/gross rental income

EXAMPLE 2
In Mr. Smith's example, the gross income multiplier is:

$$\$219,000 / \$23,600 = 9.28$$

A duplex in the similar neighborhood may be valued at "8 times annual gross." Thus, if its annual gross rental income amounts to $23,600, the value would be taken as $188,800 (8 x $23,600). Warning: This approach should be used with caution. Different properties have different operating expenses which must be taken into account in determining the value of a property.

- Net Income Multiplier. Net income multiplier is calculated as: Purchase price/net operating income (NOI)

In Mr. Smith's example, the net income multiplier is:

$$\$219,000 / \$18,618 = 11.76$$

- Capitalization rate. Capitalization rate is almost the same as the net income multiplier, only used more often. It is the reciprocal of the net income multiplier. That is:

Net operating income (NOI)/purchase price

Note: This rate is equivalent to the price earnings (P/E) ratio found in the analysis of stock.

EXAMPLE 3

Let us go back to Mr. Smith's example. The duplex's capitalization rate is $18,618/$219,000 = 8.5%. Whether it is over-priced or not depends on the rate of the similar type property derived from the market place. Suppose the market rate is 10%. That means the fair market value of the similar duplex is $18,618/10% =$186,180. Mr. Smith may be overpaying for this property.

SHOULD YOU USE LEVERAGE WHEN INVESTING IN REAL ESTATE?

Leverage means use of other people's money (OPM) in an effort to increase the reward for investing. To a lot of people, it means risk. The fact of the matter is, using leverage in real estate investing is an exciting way to earn big yields on small dollars, and you should not fear taking a chance. When you are building real estate wealth, leverage will help you grow quickly without involving too much risk (as long as you watch out for some pitfalls, which will be discussed later). High-leveraged investing in real estate is especially powerful when inflation is in full swing. High-leverage investors have numbers going for them because property values rise faster than the interest charges on their borrowed money.

To see the full power of high-leverage investing, take a look at the following example:

EXAMPLE 4

You pay a seller $100,000 cash for a piece of property. During the next 12 months, the property appreciates 5 percent and grows in resale value to $105,000. The $5,000 gain equals a 5 percent yield on your investment. But suppose you had put down only 10 percent ($10,000) in the property and mortgaged the balance. Now, your return on investment leaps to an astonishing 50 percent! ($5,000/$10,000). Another way of looking at the result is: Since you only put down $10,000 on $100,000 worth of property, you actually control the asset 10 times the value of your actual cash outlay. This means 5% x 10 times = 50%. (In this example, for simplicity, we've omitted mortgage interest costs as well as the return on the $10,000 you would have invested somewhere else, plus any rental income you would have earned from the property).

Let us expand the scenario to further see the impact of leverage.

EXAMPLE 5

Instead of putting 100% down ($100,000), you put down 10% ($10,000) and bought nine more pieces of property, each costing $100,000, and each bought with 10% down ($10,000). Again assume that they appreciate at the rate of 5 percent. Therefore, your wealth increases: $5,000 a piece x 10 pieces = $50,000. All that in one year.

Tip: Tying up your wealth in one property ($100,000) cost you $45,000 ($50,000 - $5,000). Conversely, by spreading your funds over more properties and leveraging the balance, you would multiply your earnings 10 times.

Remember: The lower the amount of cash invested, the higher your return (from value appreciation and/or rental income). On the other hand, the larger your cash investment, the lower your return. Also, remember, a higher appreciation will greatly increase earnings on your leveraged investment.

PITFALLS OF HIGH-LEVERAGED REAL ESTATE INVESTING

High-leverage real estate investing sounds real good as long as you watch out for some of the pitfalls. They are:

- Property values can go down as well as up. Some types of real estate and some parts of the country are experiencing value declines.
- Select the property carefully.
- Anticipate a rising market due to a lower mortgage rate or a high inflation rate before you jump in a high-leverage world.
- Look out for negative cash flow. Income from highly leveraged property may be insufficient to cover operating expenses and debt payments. Do not overpay for property and underestimate costs. Warning: Buying for little or nothing down is easy. The difficult part is making the payments. You should try to avoid negative cash flow (Note: losses are tax deductible, however).
- Watch out for deferred maintenance. Deferred maintenance can create lots of problems down the road. You can avoid hidden costs and potential future expenditure by

bargaining for a fair (or less than market) price and reasonable terms. In any case, over-repair is poison to the high-leverage investor.

GLOSSARY

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ACCOUNT — As applied to double-entry bookkeeping, a ledger record displaying charges or debits on the left-hand side of the page and credits on the right-hand side. Each account bears either a proper name or a title descriptive of the item to which the debits and credits are applied; for example, capital account, cash account, bank account, sales account.

ACCOUNTANT — A person versed in bookkeeping methods, in the planning, installation, and analysis of financial records, and in the preparation of statements of displaying the assets and liabilities and the operating results of business and other enterprises. See also CERTIFIED PUBLIC ACCOUNTANT.

ACCOUNTS PAYABLE — A term used in double-entry bookkeeping to indicate the records of the amounts credited to others for goods and services purchased, and the amounts paid for those purchases. See ACCOUNT.

ACCOUNTS RECEIVABLE — A term used in double-entry bookkeeping to indicate the records of the amounts charged to others for goods and services sold, the amounts received. See ACCOUNT.

ACCRUAL BASIS — A method of accounting in which financial transactions are recorded prior to the actual receipt or expenditure of the funds involved in such transactions; for example, charging purchases before bills covering those purchases are paid and crediting sales before the money income represented by those sales is received.

ACCRUED INTEREST — Interest that has accumulated but which has not been paid or collected. See INTEREST.

ACID-TEST RATIO — In a BALANCE SHEET, the proportion of the sum of cash, ACCOUNTS RECEIVABLE, and the market value of securities, if any, to CURRENT LIABILITIES. If, for example, the balance sheet shows $5,000 cash, $1,000 in accounts receivable, and securities valued at $3,000, and the current liabilities amount to $3,000, the acid-test ratio is 3 to 1. The acid-test ratio is frequently used as one test to determine CREDIT RATING. Sometimes called "quick ratio." See RATIO.

ACKNOWLEDGMENT	A personal declaration before a notary, judge, or other official that a certain act is one's own. The act of signing certain documents is often required to be so acknowledged in order to make certain the identity of the person signing the document.
ADD-ON-LOAN	See INSTALLMENT INTEREST.
AMORTIZATION	A provision made in advance for the gradual liquidation of a future obligation by periodic charges against the capital account or by the creation of a money fund sufficient to meet the obligation when due. As applied to finance, a reduction in the cost of a bond bought at a PREMIUM to reduce the cost to the par at maturity. Annual amortization is the amount of the premium divided by the number of years to maturity.
APPRAISAL	A formal valuation of property, especially for levying property taxes or customs duties, made by a competent authority.
APPRECIATION	A more or less permanent increase in value because of an upward change in the market price or because of inherent qualities that enhance the desirability thereof.
ARTICLES OF INCORPORATION	A document setting forth the purpose, duration, principal place of business, and other details of a proposed corporation. It is submitted to an appropriate government official for approval, and, if approved, copies of the document must usually be filed in one or more government offices in order that the existence of the corporation be made a matter of public record. Also called "certificate of incorporation."
ASSET	As used in accounting, something of value that is owned.
ASSET AND LIABILITY STATEMENT	Usually a balance sheet. See FINANCIAL STATEMENT.
ASSIGNEE	One to whom a title, interest, or right of some kind has been transferred. The person from whom the transfer is received is the assignor.
ASSIGNMENT	The formal transfer of any property or right from one person to another.

BALANCE SHEET	A summarized statement showing the profits, losses, assets, liabilities, net worth, etc. of a business, usually figured at the close of a fiscal period; abbreviated "b.s."
BALLOON NOTE	A promissory note which requires only token payments during the early period of the loan, more substantial payments being deferred until near the date of maturity. See NOTE.
BALLOON PAYMENT	The bulk payment that retires a loan when minimal previous payments have not fully amortized it.
BANK	A general and somewhat vague term applied to many different kinds of financial institutions carrying on one or more of the functions of deposit, discount, investment, and issue, and offering other financial services of various kinds. There are also many financial institutions not designated as banks which carry on one or more of the functions above mentioned.
BANK ACCOUNT	Money deposited in a bank and subject to withdrawal by an depositor.
BANK BILLS	A bank note; a bill of exchange issued or accepted by a bank.
BANK BOOK	The book in which the account of a depositor in a bank is recorded: also called *passbook*.
BANK DISCOUNT	Interest deducted by a bank from a loan when the loan is made: it is equal to the normal interest from the date of the loan to the date of the final payment.
BANK DRAFT	A draft or bill of exchange drawn by a bank on another bank: abbreviated "B/D."
BANK RATE	The rate of interest or discount for business loans which is prevalent among commercial banks. See RATE. See also PRIME RATE.
BANK TERM LOAN	A bank loan terminating in a year or more. See LOAN.

BILLS PAYABLE	A list of debts due to be paid by an individual or company.
BILLS RECEIVABLE	A list of debts owed to an individual or company.
BOOKKEEPING	The systematic recording of business transactions so as to show the state of a business at any time. See also DOUBLE ENTRY, SINGLE ENTRY.
BORROWING	Obtaining funds through loans, the evidence of indebtedness taking the form of promissory notes, bonds, or other credit instruments.
BUSINESS	1. *Business* refers generally to the buying and selling of commodities and services and connotes a profit motive; *commerce* and *trade* both refer to the distribution or exchange of commodities, especially as this involves their transportation, but commerce generally implies such activity on a large scale between cities, countries, etc.; *industry* refers chiefly to the large-scale manufacture of commodities. 2. A commercial or industrial establishment; store, factory, etc.
CALL LOAN	A loan payable on demand. See LOAN.
CASH FLOW	A statement showing all actual cash receipts and disbursements for a specifically delimited period, or showing estimates of such receipts and disbursements for some future period. See FINANCIAL STATEMENT.
CASH FLOW POSITION	The presence or absence of surplus cash for recycling into business operation (sometimes known as "positive" or "negative" cash flow).
CERTIFIED PUBLIC ACCOUNTANT	An accountant who has received a certificate stating that he has met the requirements of State law: abbreviated "C.P.A."
CHATTEL	Almost any kind of personal property; this may include an interest in real estate which is less than a freehold, as a lease.
CHATTEL MORTGAGE	An instrument in which personal property earmarked as security for a debt or other obligation and pledged in such a way that if the debtor fails to meet the terms of the contract, the creditor can take possession of the property. See MORTGAGE.

CIRCULATING CAPITAL GOOD	A term used in contradistinction to FIXED CAPITAL GOOD.
CLOSED MORTGAGE	A mortgage used as collateral security for a loan of a fixed amount and which, therefore, cannot be used as security for additional loans of any kind. See MORTGAGE.
COLLATERAL	Property, or evidence thereof, deposited with a creditor to guarantee the payment of a loan.
COMMERCIAL BANK	A bank, the principal function of which is to receive deposits subject to check, and to make loans to its customers. Besides these primary banking functions a commercial bank performs a variety of incidental functions. It keeps the community supplied with various kinds of legal currency, acts as a collection agent for promissory notes, drafts, and similar COMMERCIAL PAPER, and transmits funds to distant points upon request. It may offer its vaults for the safekeeping of valuables, offer interest for TIME DEPOSITS, and perform the functions of a TRUST COMPANY. Commercial banks may be NATIONAL BANKS, or STATE BANKS. All national banks are commercial banks. See BANK.
COMMERCIAL CREDIT	Short-term loans furnished a business undertaking for temporary needs. See CREDIT.
COMMERCIAL CREDIT COMPANY	A company engaged in certain specialized forms of financing, particularly the purchasing of accounts receivable, and the discounting of installment accounts. See COMPANY. See also FACTOR.
COMMERCIAL PAPER	Checks, promissory notes, bills of exchange, and other negotiable paper used in business.
COMMISSION	As applied to commercial transactions, compensation to a broker or agent for conducting some business project for another person. The term infers that the payment is a percentage of some amount involved in a transaction.
COMPANY	An association of persons organized for the purpose of carrying on some commercial or industrial activity. A company may be a CORPORATION or a PARTNERSHIP, or it may assume some other form of BUSINESS organization. Companies are frequently designated by some descriptive title indicating the nature of their business or their relation to some other

company, such as insurance company, operating company, parent company, and the like.

COMPOUND INTEREST — Interest added to a principal sum at uniform intervals over a period, the accumulated interest and the principal sum at any given interval providing the basis for calculating succeeding interest payments. For example, a principal sum of $1,000 at 6 percent interest, compounded annually over a three-year period, amounts to $1191.02.

$1,000.00	original principal sum
60.00	interest earned during first year
$1,060.00	principal sum beginning of second year
63.60	interest earned during second year
$1,123.60	principal sum at beginning of third year
67.42	interest earned during third year
$1,191.02	principal sum at end of third year

The generalized equation is:

$$F = P(1 + i)^n$$

F = principal at the end of the final interval
P = original principal sum
i = interest rate
n = number of intervals

In the above example:

$$1{,}191.02 = 1{,}000\ (1 + .06)^3$$

COMPTROLLER — Usually the executive head of the accounting staff of a large corporation or governmental agency who may analyze and interpret its financial position. Usually spelled "CONTROLLER."

CONSUMER CREDIT — Credit extended to consumers for the purchase of consumer goods and services. Consumer credit may be extended by means of charge accounts, an installment purchase plan, or through money loans. See CREDIT.

CONFORMING — Loans that conform to Federal Home Loan Mortgage Corporation

LOANS	(FHLMC) and Fannie Mae (FNMA) requirement(s) and do not exceed the maximum loan amount and loan-to-value (LTV) limitations established by FNMA or FHLMC:

Property Type	*Loan Limits*
Single Family	$417,000
Two Family	$533,850
Three Family	$645,300
Four Family	$801,950

CONTRACT — A legally binding agreement between two or more parties in which, for a consideration, one or more of the parties agree to do or not to do a certain thing.

CONTROLLER — See COMPTROLLER.

CORPORATION — A legal entity, created either for a limited period or in perpetuity, which, within the scope of its charter issued by the state, is treated in many respects as a natural person. Thus a corporation normally has the broad contractual discretion of a natural person and may own property, incur debts, and sue and be sued in a court of law. There are many types or classes of corporations, each type or class being governed by laws which normally apply only to that type or class. The corporation's control and direction are vested in its membership or board of directors or trustees. Occasionally referred to as "incorporation."

CREDIT —

1. A promise of future payment in kind or in money given in exchange for present money, goods, or services.
2. An entry on the right or credit side of an account in a DOUBLE-ENTRY system of BOOKKEEPING. See ACCOUNT.
3. The reputation as a risk which a borrower enjoys with an actual or potential lender.

CREDITOR — One to whom a debt is owed.

CREDIT RATING — A rating given a business establishment by a mercantile agency indicating that establishment's record of performance in meeting its financial obligations and its ability to meet such obligations in the future.

CURRENT ASSET	An asset which is temporary in character and hence will be transformed or converted into cash within a relatively short period, usually a year. In financial statements current assets are usually listed according to the degree of liquidity; for example, cash, ACCOUNTS RECEIVABLE, BILLS RECEIVABLE, and INVENTORY. Sometimes called "floating asset." See ASSET.
CURRENT DEBT	Debts due within a year, including payments on long-term loans and any anticipated payables such as taxes.
CURRENT LIABILITY	A liability which is due within a comparatively short time, usually less than a year. See LIABILITY.
CURRENT	In a BALANCE SHEET, the proportion of total CURRENT RATIO ASSETS to total CURRENT LIABILITIES. If the current assets are $6,000 and current liabilities $4,000, the current ratio is 1-1/2 to 1. Current ratio is frequently used as one test to determine CREDIT RATING.
DEBIT	An entry on the left of "debit" side of an account in double-entry bookkeeping. An account may be said to have a debit balance if the amounts debited are in excess of the amounts credited.
DEBT	Whatever is owed to one person or organization by another. The obligation may involve money, goods, or services.
DEBTOR	One who owes a debt - the opposite of a creditor.
DEBT SERVICE	Payment of the interest on a debt and of such installments of the principal as are legally due.
DEED	A written document setting forth an agreement, particularly an agreement involving the transfer of property, the document having been duly signed, sealed, and delivered. Commonly the term refers to a document transferring the ownership of real property.
DEFICIT	A deficiency usually expressed in money. On books of account it is the amount necessary to balance an asset and liability statement when the liabilities exceed the assets.
DEPRECIATION	In accounting, calculation, by one of various standardized methods, of the decline in value of an asset.

DIRECT REDUCTION MORTGAGE	A mortgage that is completely liquidated by a series of equal monthly payments for interest and amortization charges during its term. This type of mortgage came into common use during the 1930's. See MORTGAGE.
DISCOUNT	A deduction made from a debt or charge, such as an amount deducted from a bill for prompt payment.
DISCOUNT LOAN	See INSTALLMENT INTEREST.
DISCOUNT RATE	The percentage of discount charged by banks and similar institutions for purchasing loans or commercial paper in advance of the date of maturity and providing the owner with the net proceeds (face value less the discount charge). See RATE.
DOUBLE ENTRY	A system of bookkeeping in which every transaction is entered as both a debit and a credit.
DRAFT	A written order for a definite sum of money, originating with a creditor and naming a debtor, customarily forwarded to a bank for collection. Upon receipt of a draft, the bank presents it to the debtor for payment. If paid the original document is retained by the debtor as a receipt. Sight drafts are payable at once. Time drafts are payable at some future time specified on the document.
EARNINGS	See PROFIT.
ENTREPRENEUR	A person who, in the course of production, assumes the responsibilities of organization, management, and risk.
ESCROW	Property placed by one person in the hands of a second person, usually a trust company, for delivery to a third person upon the fulfillment by the latter of certain specific obligations.
ESTATE	Specifically, the nature and extent of a person's ownership of real property. The term is frequently broadened, however, to include personal property.

EXCHANGE

1. The payment of debts by negotiable drafts or bills of exchange, without actual transfer of money.
2. A bill of exchange.
3. A fee paid for settling accounts or collecting a draft, bill of exchange, etc.
4. An exchanging of a sum of money of one country or of a depreciated issue for the equivalent in the money of another country or of a current issue.
5. The rate of exchange; value of one currency in terms of the other; difference in value between currencies.
6. The checks, drafts, etc. presented for exchange and settlement between banks in a clearinghouse.
7. In finance, to pass in exchange: as, the currency of this country *exchanges* at par.

FACTOR

As used in commerce, a firm or other organization which, under a continuous contract with a client, purchases his accounts receivable, with or without recourse, advances funds on open credit or on the security of inventories or fixed assets, and offers auxiliary services in such areas as marketing, sales analysis, and management. Before 1930, factoring was confined largely to the textile industry where it was customarily combined with selling services. Currently, it is being used by an increasing number of concerns in various lines of business.

FACTORAGE

The commission received by a FACTOR.

FEDERAL HOUSING ADMINISTRATION

A unit of the U.S. Department of Housing and Urban Development which insures private lending institutions against loss on loans secured by residential mortgages and loans advanced for repairs, alterations, and improvements which may be secured by collateral.

FEDERAL NATIONAL MORTGAGE ASSOCIATION

A public corporation, popularly called Fannie Mae, chartered originally in 1938 and now part of the Department of Housing and Urban Affairs. It lends funds, secured by mortgages, to public and private agencies for the construction of low rental housing units. Its principal aim is to maintain the liquidity of the mortgage market and to that end, from time to time, it purchases or guarantees mortgages. It also is responsible for the management of its own rather sizable mortgage portfolio. Under the Housing and Urban Development Act of 1968, the agency became a "government-sponsored" private corporation.

FIDUCIARY	A person who holds property in trust for the benefit of others. Guardians and trustees act in the capacity of a fiduciary.
FINANCIAL STATEMENT	A presentation of financial data obtained from accounting records.
FIXED ASSET	An asset of such a nature that it is used directly or indirectly to produce goods or services and is not for sale in the regular course of business. Examples are land, buildings, and machinery. See ASSET.
FIXED CAPITAL GOOD	A capital good which is relatively durable. The term is used in contradistinction to CIRCULATING CAPITAL GOOD. See GOODS(S).
FIXED COST	A cost which does not necessarily increase or decrease as the total volume of production increases or decreases. Interest on borrowed capital, expenses of maintenance, and fire insurance are examples. Also called indirect, overhead and supplementary cost.
FIXED LIABILITY	A liability which is not due for at least a year from the time it is incurred. Also known as long-term liability. See also LIABILITY.
FORCED LOAN	A loan made because of some exigency; for example, a loan that cannot be collected at maturity and which is therefore renewed, or the payment by a bank of an OVERDRAFT which is later converted into a formal loan. See LOAN.
FORECLOSURE	As applied to mortgages, a sale under a judgment held when a mortgagor fails to make payments on the debt secured by a mortgage, the right to redemption being retained by the mortgagor. If the mortgagor fails to redeem the property upon notice, he is forever barred from exercising any such right.
FREE AND CLEAR	The absence of any liens or other legal encumbrances on property.
GARNISH	In law, to bring garnishment proceedings against; garnishee.
GARNISHEE	In law, a person who has money or other property of a defendant in his possession, and is ordered not to dispose of it pending settlement of the lawsuit.

GARNISHMENT	In law, a summons to a person other than the litigants to appear in a lawsuit; a notice ordering a person not to dispose of a defendant's property or money in his possession pending settlement of the lawsuit.
GOING BUSINESS	Viable firm conducting its regular business; a going concern. See GOOD WILL.
GOOD(S)	Movable personal property; merchandise; wares.
GOOD FAITH	Observance of honorable intent in business relations and avoidance of any attempt to deceive or mislead in assuming and discharging contractual obligations.
GOOD WILL	As used in an asset and liability statement, the value imputed to a name or reputation. Presumably an established name or favorable reputation assures a certain amount of continuing business which a new establishment would not enjoy. This probability of continued business is an asset, and its value is usually considered when a GOING BUSINESS is sold.
GRACE PERIOD	A period - usually 3 days - after a debt falls due, during which the debtor may occasionally be permitted to delay fulfillment of his obligation without incurring a penalty or other liability. Commonly referred to as "days of grace."
GROSS INCOME	The term may refer to the total receipts of an enterprise or it may refer to the total receipts less certain expenses. Modern income or profit-and-loss statements customarily group expense accounts into certain broad classifications such as cost of goods sold, selling expenses, operating expenses, etc. In such statements the term "gross income" is frequently used to indicate the amount remaining after the total "costs of goods sold" only has been deducted from the total sales. Other expenses are then deducted until the NET INCOME is finally computed. In the accounts required of some public-utility companies, the term is used to indicate the amount remaining after all the expenses have been deducted except debt charges and a few other items. See INCOME.
GROSS INTEREST	A price paid for the use of capital which includes a sum to cover the risk involved and a sum to cover the administration costs incurred in making the loan. The customary price paid for the use of capital is gross interest but is customarily referred to as merely INTEREST. See INTEREST.

HOLDING COMPANY	A corporation which holds a sufficient quantity of the stock of some other corporation, usually an operating company, to permit it to direct its affairs. Sometimes referred to as a controlling company.
HYPOTHECATE	The act of pledging and depositing property to secure a loan. The property in question is then said to be hypothecated.
INCOME	The money or other gain periodically received by an individual, corporation, etc. for labor or services, or from property, investments, operations, etc., abbreviated "inc."
INCOME STATEMENT	See PROFIT-AND-LOSS STATEMENT.
INSTALLMENT INTEREST	A sum payable on a debt, as for purchased articles, at regular times over a specified period.
INTEREST	A sum paid or calculated for the use of capital. The sum is usually expressed in terms of a RATE or percentage of the capital involved, called the interest rate.
INVENTORY	1. An itemized list or catalog of goods, property, etc.; especially, such a list of the stock of a business, taken annually. 2. The store of goods, etc., which are or may be so listed; stock. Abbreviated "invt."
IRREVOCABLE LETTER OF CREDIT	See LETTER OF CREDIT.
LEASE	A contract for the possession of specified property for the life of the party to whom the property is conveyed or for a period specified in the contract. See also NET LEASE.
LEASEBACK	A transaction involving the sale of assets such as real estate or equipment, the purchased property then being leased to the original owner for a term of years. The prime purposes of the transaction are to provide the seller with more liquid assets for the expansion of his business and to permit him to charge off the rental on his tax return as a business expense.
LETTER OF	A document, usually issued by a bank, in which the issuer agrees to accept

CREDIT — drafts, under conditions set forth in the document, to be charged against credit previously established. The main types of letters of credit may be classified according to the extent of the liability assumed by the bank issuing a letter, and again by the use to which the letter is put.

Widely used terms indicating the bank's liability are as follows:

(a) *Confirmed letter of credit*; a letter in which the payment of all drafts drawn against it is guaranteed.
(b) *Irrevocable letter of credit*; one that cannot be canceled until a certain stipulated period expires.
(c) *Revocable letter of credit*; one that may be canceled at any time.
(d) *Straight letter of credit*; one that is confirmed and irrevocable.
(e) *Unconfirmed letter of credit*; one for which credit has been established, but for which the issuing bank does not itself guarantee payment.

There are also terms indicating the use of letters of credit:

(a) A *circular letter of credit* is one not directed to any particular person, concern, or bank. When the beneficiary wishes to use it, he must find some agency willing to negotiate a draft.
(b) An *open letter of credit* contains no special stipulations. It is used, for example, when payments are desired without any documents being submitted with the draft drawn against the letter.
(c) A *revolving letter of credit* is one in which credit is automatically renewed as drafts are drawn against it. It is used frequently to facilitate payments by purchasing agents traveling abroad.
(d) A *traveler's letter of credit* is directed to any one of a number of correspondent banks, a separate list of which is given to the beneficiary. He may then call upon any bank named on the list, identify himself by a signature card given him by the issuing bank, and draw on the credit previously established. A record of the amount drawn is then noted on the letter of credit.

LIABILITY — A debt or obligation stated in terms of money. Net worth is an obligation of an enterprise to the owners, although payable, in the case of a corporation, only through declaration of a dividend or liquidation. Liabilities are a part of a BALANCE SHEET. The other part consists of ASSETS.

LOAN — As generally used in business, a sum of money borrowed from a commercial bank at the prevailing rate of interest. When bonds are sold by a borrower or when a borrower pledges a mortgage as security, the term may be qualified as long-term loan or mortgage loan. The term generally refers to a money transaction, the terms hire, rent, or lease customarily being used when goods are borrowed.

LOAN INTEREST A price paid by one person to another for the use of capital.

LONG-TERM LIABILITY See FIXED LIABILITY.

MODULAR HOUSING Units of prefabricated houses that can be joined horizontally or vertically to form a contiguous connected unit.

MORTGAGE 1. A conditional conveyance of property as security for the payment of a debt or the performance of some other obligation.
2. A contract specifying that certain property is hypothecated for the payment of a debt or for the performance of some other obligation.

MORTGAGEE A person who grants a loan secured by a mortgage and to whom the mortgage is given. See also MORTGAGE.

MORTGAGOR A person who gives a mortgage on his property as security for a loan. See MORTGAGE.

NATIONAL BANK 1. A bank which manages and controls the finances of a nation.
2. In the United States, a bank chartered by the Federal government and under certain controls by the Federal Reserve System, of which it is a member: national banks formerly issued bank notes secured by government bonds.

NATIONAL INCOME The total income of a nation, including all profits, rents, interest, wages, salaries, etc., during a specified period, usually a year.

NET INCOME As normally used in accounting practice, whatever remains from earnings and profits after all costs, expenses, and allowances for depreciation and probable losses have been deducted. Thus used, the term is usually synonymous with net profits.

NET A lease requiring the tenant to pay the taxes and insurance and the cost of

LEASE	repairs, maintenance, alterations, and improvements on the leased property.
NET WORTH	In accounting, total assets minus total liabilities, the difference being what would accrue to stockholders or other owners in the event of liquidation.
NON-RECOURSE LOANS	A loan, security for which is limited to the value of pledged collateral and for which, indeed, the only repayment may be the money equivalent which the lender obtains for the pledged collateral. The term is particularly applicable to the federal government's loans to farmers on surplus commodities, the farmers' obligation to the government lending agency being limited to the commodities pledged for the loan. See LOAN.
NOTE	A credit instrument having general or limited negotiability, issued by an individual, a private corporation, or a governmental body, and consisting of a promise to pay a sum of money to a named creditor or to the bearer either on demand or at a specified time.
NOTES PAYABLE	See BILLS PAYABLE.
NOTES RECEIVABLE	See BILLS RECEIVABLE.
OPEN MORTGAGE	A mortgage which, having been pledged as collateral security for a loan, may be increased while serving as such collateral, thereby diminishing the security originally provided for each dollar of the loan. See MORTGAGE.
OPERATING PROFIT	As used in accounting, an increase in wealth resulting from the regular activities of an enterprise, as distinguished from any activities foreign to that business. For example, income or other gain from financial investments of a mercantile establishment would not be a part of the operating profits of that establishment. See PROFIT.
OVERDRAFT	1. A withdrawal of money from a bank in excess of the amount credited to the drawer. 2. The amount withdrawn in excess. Abbreviated "O.D."
PARTNERSHIP	An association of two or more people who contribute money or property to carry on a joint business and who share profits or losses in certain proportion; a contract by which such an association is created; the people so associated.

PERSONAL FINANCE COMPANY An enterprise which makes a business of lending relatively small sums of money at relatively high rates of interest to individuals for personal needs. In most states such companies must be licensed.

PERSONAL INCOME In government statistics, the NATIONAL INCOME less undivided profits, corporate taxes, and social security tax contributions, plus TRANSFER PAYMENTS from government or business including social security benefits and military pensions. It includes non-monetary items such as net rental income to home owner occupants, gratuitous services from financial intermediaries, and the value of food raised and consumed on farms. Personal income, thus defined, applies to non-profit institutions, private trust funds, and private health and welfare funds, as well as to individuals.

PERSONAL PROPERTY A right or interest in things other than real property; for example, such things as money, clothing, and household furnishings, as well as bonds, stock mortgages, and other evidences of interest or debt.

POWER OF ATTORNEY Authority granted to one person to act on behalf of attorney authorizes the agent to act for the principal in all matters. A special power of attorney limits the agent's acts to specific matters.

PREMIUM

1. An additional amount paid or charged; specifically:
   (a) An amount paid for a loan in addition to interest;
   (b) An amount paid, as for stock, above the nominal or par value.

2. A payment; specifically:
   (a) The amount payable or paid, in one sum or periodically, for an insurance policy;
   (b) A fee paid for instruction in a trade, etc.
   (c) A fee paid by a borrower of stock to the lender.

3. In economics, the amount by which one form of money exceeds another (of the same nominal value) in exchange value, or buying power.

PRIME RATE The interest rate which is charged business borrowers having the highest CREDIT RATING. See RATE.

PROFIT	1. A financial or monetary gain obtained from the use of capital in a transaction or series of transactions. 2. The ratio of this to the amount of capital invested. 3. The proceeds from property or the like. 4. In economics, the net income, as of a business, or the difference between the income and the costs, direct and indirect.
PROFIT-AND-LOSS STATEMENT	A condensed account of the operations of a business enterprise for a period, usually 1 year. Such an account sets forth the total sales, the cost of goods or services sold, and the gross profit or loss. The expenses of running the business are then listed under general classifications to arrive at net operating profit or loss. Other income is subsequently added and other expenses are deducted to show net profit or net loss. Also called income statement.
PROMISSORY NOTE	A written promise to pay a specific amount of money to some person at a given place and time with interest at a specific rate, or without interest, as the case may be.
PROPERTY	1. The right to possess, use, and dispose of something; ownership: as, *property* in land. 2. A thing or things owned; holdings or possessions collectively; especially, land or real estate owned. 3. A specific piece of land or real estate.
PURCHASE-MONEY MORTGAGE	A mortgage given wholly or in part in lieu of cash for the purchase of tangible property. See MORTGAGE.
RATE	1. A fixed ratio; proportion: as, the rate of exchange. See EXCHANGE. 2. A price or value; specifically, the cost per unit of some commodity, service, etc., e.g. insurance *rate*.
RATIO	In finance, the relative value of gold and silver in a currency system based on both.
REAL PROPERTY	A right or interest in land or whatever is attached to that land in such a way that it cannot be readily moved. The term is used in contradistinction to PERSONAL PROPERTY. See PROPERTY.
REVOCABLE	See LETTER OF CREDIT.

LETTER OF CREDIT	
REVOLVING LETTER OF CREDIT	See LETTER OF CREDIT.
RISK CAPITAL	See VENTURE CAPITAL.
ROLLING STOCK	The physical property of a railroad that operates on its own wheels on rails. Locomotives, passenger and freight cars, wrecking derricks, etc., are a part of the rolling stock of a railroad.
SECURED DEBT	A debt for which collateral has been pledged. See DEBT.
SECURITY	1. A document establishing a right to some form of property; for example, a corporate stock certificate, a bond, or a mortgage. 2. Property pledged as collateral. 3. Insurance against risk.
SIMPLE INTEREST	Interest calculated on a principal sum but not on any interest that has been earned by that principal sum. See INTEREST.
SINGLE ENTRY	A system of bookkeeping in which the only account kept is a single one consisting of debts owed to and by the concern in question.
SMALL BUSINESS	As defined by the U.S. Small Business Administration: wholesalers with annual sales of not more than $10 to $15 million; retailers with annual sales of not more than $5 million; manufacturers with from 250 to 1,000 employees. These limits often depend upon the nature of the Business.
SMALL BUSINESS INVESTMENT COMPANY	A closed-end, non-diversified investment company, licensed under the Small Business Investment Act of 1958, which provides long-term loans too small businesses, purchases the equity securities of such concerns, and makes available to them consulting and managerial services.
STATE BANK	A bank controlled or chartered by a state.

TIME DEPOSIT — A bank deposit payable at a specified future date or upon advance notice: abbreviated "T/D".

TIME — A loan made for a definite period. The term is used in LOAN contradistinction to CALL LOAN.

TRANSFER PAYMENTS — To make over the legal title, right or ownership of to another.

TRUST COMPANY
1. A company formed to act as trustee.
2. A bank organized to handle trusts and carry on all banking operations except the issuance of bank notes.

TRUSTEE
1. A person to whom another's property or the management of another's property is entrusted.
2. Any of a group or board of persons appointed to manage the affairs of a college, hospital, etc.
3. A person in whose hands the property of a debtor is attached by the trustee process; garnishee. See GARNISH.

TRUTH-IN-LENDING ACT — An act of Congress, 1968, requiring that a consumer borrower be informed of the true cost of a loan. Among specific regulations in the act are:
(a) the interest rate on revolving charge accounts must be disclosed;
(b) the true annual interest rate on home mortgages must be revealed;
(c) the actual interest rate must be given in a credit advertisement if the advertisement is in figures;
(d) the cost of credit life insurance on a loan must be stated; and
(e) a specific limitation, effective in 1970, is placed on the power to GARNISH wages.

UNSECURED DEBT — A debt for which no specific collateral has been pledged.

USURY — Interest in excess of a maximum established by laws applicable to various types of loan transactions. In popular speech the term is frequently applied to any rate of interest considered to be unfair and unjust.

VENTURE CAPITAL

Capital subject to a considerable risk; hence, also called *risk capital*. Capital invested in a new business, where the chances of success are uncertain, is an example.

WORKING CAPITAL

Current assets of an enterprise less the amount of the current liabilities. That part of the current assets which is equal to the current liabilities must be reserved to meet the enterprise's short-term debts. What remains of current assets is available for other uses in the business and hence is working capital.

APPENDIX

USEFUL WEBSITES

Primary Focus	*Web Address*
Mortgage lending and real estate	
ABC's of real estate and mortgage lending	http://www.realestateabc.com/
Real estate ABC—home price check	http://realestateabc.homepricecheck.com/common/bp/hpc/
IPIX-Internet Pictures Corporation	http://www.ipix.com/
MSN Home Advisor—Find homes and loans	http://realestate.msn.com/
Search for lenders, rates nationwide	http://www.lonz.com
Compares rates of 100 lenders and 64 loan programs, moving and real estate agent referrals	http://www.monstermoving.monster.com/
Mortgages and home equity loans	http://www.bankrate.com
E*Loan	http://www.eloan.com/
Lendingtree.com--mortgage loans	http://www.lendingtree.com/
Home mortgage loans	http://www.homeshark.com/
Mortgage and rates site of Intuit	http://www.quickenloans.com/ /
Prudential site	http://www.prudential.com/
Coldwell Banker site	http://www.coldwellbanker.com/
Dataquick site	http://www.dataquick.com/
Credit scoring	
Fair, Isaac & Company site	http://www.myfico.com/
E*Loan	http://www.eloan.com/
Credit report	
Trans Union LLC	http://www.transunion.com
Equifax	http://www.equifax.com
Experian National Consumer Assistance Center	http://www.esperian.com
Factoring, equipment, inventory financing	
American Cash Flow Institute--Factoring	http://www.acfi-online.com/
American Cash Flow Association--Factoring	http://www.acfa-cashflow.com/
Small business assistance	

U.S. Small Business Administration (SBA)	http://www.sba.gov
Service Corps of Retired Executives (SCORE)	http:// www.score.org
Financing sources--borrowing and venture capital	
The National Venture Capital Assn.	http://www.nvca.org
The National Financial Services Network	http://www.nfsn.com
Commercial Finance Online	http://www.cfol.com
The Capital Network	http://www.thecapitalnetwork.com
Garage.com	http://www.garage.com

CREDIT REPORTING AGENCIES

- Experian - PO Box 2104 - Allen, TX 75013 1-800-682-7654
- TransUnion - PO Box 390 - Springfield, PA 1-800-916-8800
- Equifax - PO Box 105873 - Atlanta, GA 1-800-685-1111