Average Executive
Reading Time: 4 min.

Alternatives in Financing

With today's high interest rates, real estate people must have solid expertise in creative financing, tax shelters through equity purchases, and money market trends.

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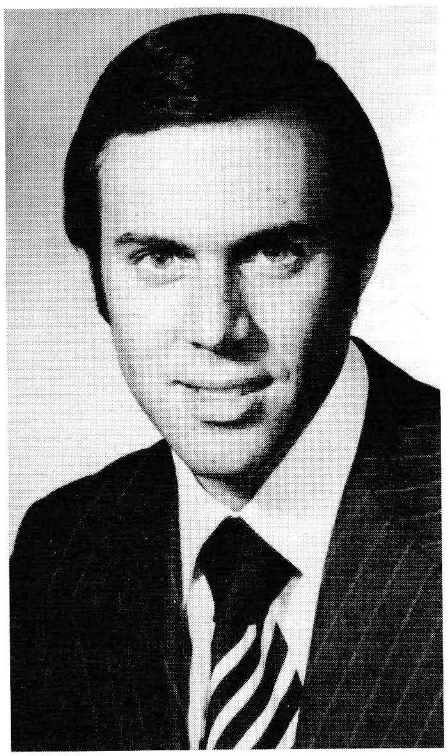
TO STATE that the real estate industry is in a recession would clearly be an understatement. Market conditions are more indicative of a depression. It is *not* that there are too many or too few buyers or sellers; and it is not that there is too little product available. The problem is the *cost* of purchasing the product. As an alternative, it has become increasingly necessary to obtain knowledge and develop expertise in various methods of creative financing.

There are numerous options available as alternatives in financing that reduce the cost of mortgage financing below the current conventional rates. FHA, for example, offers a standard or basic single-family residential program for loans up to 95% of the purchase price with a maximum loan amount of $67,500. The current interest rate on these loans is 11.5%. There is also a Graduated Payment Plan (GPM) available with a maximum loan ceiling of $67,500. The interest rate is 11.5%, however, because payments are graduated over a three to five-year period; the effective rate during the first year of the loan is about 9% with the rate escalating slowly until it averages out to 11.5%.



The major drawbacks with FHA financing are (1) the limitation on the maximum loan amount; and (2) the seller has to pay discount points which currently range from 2% to 6%. Competent real estate agents should, however, when dealing with FHA financing, attempt to educate their sellers to accept an offer closer to the asking price in order to cover the points that have to be paid, rather than accepting an offer of 6% to 10% lower which is the customary practice.

VA loans include programs similar to FHA, the major differences being that they offer financing up to 100% of the purchase price and the maximum loan amount is higher. The VA does not offer a GPM program.

Newer Plans

Two relatively new conventional mortgage plans that are becoming increasingly more popular are the Renegotiable Rate Mortgage (RRM) and the Graduated Payment Mortgage (GPM). With the RRM plan, the interest rate can be adjusted up or down every three to five years and as much as 5% over the entire 30-year life of the mortgage. Loans are made for three, four or five-year periods, amortized over 30 years. At maturity the loan is renewed for a like period at the then-current rate either up or down. However, regardless of the current market rate, the new rate cannot rise more than ½% *a year* or 5% over the 30-year life. If the original mortgage rate begins at 12%, the highest it could rise over 30 years would be to 17%. There is also no prepayment penalty. In addition, the borrower must be given 90 days notice when the loan is due for renewal, thus allowing him the opportunity to shop elsewhere. The borrower can also partially prepay the loan and reamortize the new balance to reduce the monthly payments.

The Graduated Payment Mortgage is now available mainly to developers, although we should see more of this means of financing becoming available to individual buyers. Currently, a borrower receives a mortgage at 12% to 13% plus a service charge of 2% to 3%. The developer pays an additional commitment fee to subsidize the lender's yield. Part of the purchaser's downpayment is applied to the purchase price and the remainder is placed in an interest-bearing pledge account with the lender.

Growing Loan Balance

The graduated payment provision reduces the effective interest rate on the loan to about 9½% in the first year, 10½% in the second year, and 11¾% in the third year. Because of the reduced monthly payment during the first three years, the loan balance actually grows instead of declining. Therefore, the portion of the down payment placed in the pledge account is used to help reduce the mortgage amortization in the early years of the loan. At the end of the three years, the lender will renegotiate the loan for an additional three-year period at the then current market rate. This process continues in three-year intervals up to 30 years.

Another variation to the Graduated Payment Mortgage is the Negative Amortization Program which is similar in fashion, but does not include a pledge account. Like the GPM, a portion of the interest in the early years is deferred. This deferred interest is then added onto the principal balance. Thus, the loan amortizes negatively during the graduation period and begins to amortize normally at the end of this period. All of these programs enable a purchaser to qualify for a larger mortgage, which is a key factor in stimulating today's market.

Owner As Bank

Owner financing is another important alternative means of financing in a high-interest market. The owner requires a specific amount as the down payment and then acts as the bank by holding what would technically be a second mortgage at a lower rate than the current conventional rate. The balance of the mortgage is usually due anywhere from three to five years later, at which time the purchaser would obtain conventional financing. The original seller is sometimes subject to the acceleration clause or "due-on-sale" clause, should the original lender call for the balance of the loan.

Some lenders have begun to assume existing mortgages at a slightly higher interest rate than the existing mortgage, with conventional financing on the additional monies borrowed. For example, if a property is sold with an existing mortgage at 10%, the buyer assumes the balance of that mortgage at 12% as a new loan, with conventional financing on additional monies borrowed. The two interest rates are then averaged and this new weighted average is the approved rate on the loan. Although most banks at this time are not publicly agreeing to offer assumable mortgages, a mortgage banker or professional third party can usually (and more effectively) negotiate this plan with a financial institution.

In these high-interest times, those involved in the real estate industry must have expertise in alternative methods of financing. There will always be buyers and sellers and ways of putting deals together. The current market demands a greater knowledge of creative financing, tax shelters through equity purchases, and money market trends. □