Making a Great Spread on the Equity in your Home

Do you have a home or a rental property that has Equity in it? If so, you might consider borrowing from the Bank and then lend those funds out in the form of a private mortgage loan. By doing so, you are taking advantage of the difference between the lower borrowing rate of the Banks and the higher interest rate you can achieve as a private mortgage lender. Depending on several factors, this spread can range between 5% and 16%. This investment vehicle is generally underutilized.

I have conservative private lending clients that are borrowing at today's lower interest rates. Pro Funds is currently able to secure mortgage interest rates from 2.90% on residential first mortgage loans for a 5-year term and up to 35-year amortization. We have assisted these clients in finding good secure mortgage investments yielding returns in the 5-16% range. Another benefit of this approach is the ability to pay down your Bank mortgage much quicker.

Banks are offering up to 80% of the value of your home in a refinance. These mortgages typically have good repayment privileges. They can enable you to increase your monthly payments by 20% and make a further annual principal payment of 20% of the loan amount as well. One caveat here is that most institutions will limit the amount of cash extracted to $200,000.

Let's talk about risks. Some people view private mortgage lending as a high risk investment (and this is the reason behind the much higher returns). In general, there is certainly greater risk in private mortgage lending compared to say a GIC that will today pay between 1% and 2.5%. The primary risk here is that if the project you are lending on completely fails, and you are unable to remedy the situation and recover your investment, you could jeopardize your original equity. Yes, there are mortgage offerings that can be excessively risky. For example, dealing with mortgage lending opportunities that involve tax arrears, mortgage arrears, and/or debt overload need to be either carefully assessed (what are the actual reasons for the problems) or simply dismissed. The amount of risk is a function of who you are doing business with, to whom you are lending to and performing the proper due diligence (using qualified and experienced advisors as required). Mortgage lending is really not too complex, and many of those involved become repetitive clients.

Mortgage placements can vary largely. Private lenders may either a) lend to traditional homeowners that may not qualify with the banks based on having either poor credit or lack of "verifiable income", or b) lend to like-minded people that are real estate investors or developers.

So, you may ask: Why would individuals with good credit and high net worth have to borrow private funds?
Government rules and financial institutions have placed restrictions on the ability of investors and self-employed business people to borrow. If a borrower is purchasing a residential rental property, and is self-employed and cannot show actual income, this borrower would not be able to obtain a Bank mortgage approval. This means that if you are self-employed and cannot show actual income, you may not qualify for the required financing. This is unfortunate for many self-employed borrowers. However, this does create opportunities for private lenders. Private lenders can get involved in safe placements with good solid returns on their mortgage loan investment.

Over the last decade, we have worked hard to co-ordinate successful lending and borrowing for our many clients. Proper review, helpful advice and due diligence has been key to the overall success of all parties involved. The result is a solid book of business and deal flow.

The process of a private mortgage deal is as follows: When the mortgage brokerage receives a mortgage request, required information is gathered and the potential placement is assessed. We review due diligence material which may include mortgage application, credit bureau report, property description, property financial statements and rent roll (if applicable), local market description, appraisal or valuation, existing mortgage information, realty tax information, reasons for the loan and how the funds will be used. We prepare an overview of the project and funding requirement. If the mortgage request and real estate have merit, we approach prospective lenders with the opportunity. If interest is expressed, and subject to lender qualifications and confidentiality agreements, we will provide the due diligence package for lender review. Lenders will also be provided with the interest rate and lender fee payable (by borrower to lender) on the deal, which will be deemed fair for both parties. If you as the potential Lender agree to proceed, our firm will prepare certain legal documents and co-ordinate a commitment agreement between the lender and borrower.

It is very important to understand this loan commitment. On one side, you the lender are committing to a mortgage investment and a placement of funds. On the other side, the borrower is committing to provide security in the form of a mortgage and is relying on these funds to close a purchase of a property or to refinance for other reasons.

The prepared mortgage documents will then be sent to the lawyer of the lenders' choice. The borrower will pay for their own legal fees as well as the lender's legal fees. There is no cost to the lender. The monthly payments are typically interest only and the term is typically one year. The borrower will pay the broker fee. The borrower will also provide post-dated cheques for the 12 months (or term). At the end of the term, the mortgage brokerage firm may send out renewal notices and offer the lender and the borrower an option for a renewal (contingent upon agreement of both parties). If the borrower is not interested in renewing, our deal flow facilitates the placement of funds in other mortgage opportunities.

Please see the example below:

Part 1: Private Lender borrows through Bank $200,000 at 2.90% interest with a 25-year amortization giving Bank mortgage security. Monthly payments work out to $936 per month.

Part 2: Private Lender invests $200,000.00 in mortgages at an average of 14% interest for a one year term. Monthly interest payments received would be $2,333 per month. The net spread to the Lender is $1,397 per month (or $16,764 over the one year term).

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