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Understanding Mortgages

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1. Introduction

Mortgages are debt contracts secured by real property. Typically they are used to purchase real property – the so called purchase money mortgage. But they may be incurred for other reasons as well. For instance they may be used to fund expenses of a business or to support personal expenditures. For whatever purpose the original mortgage was contracted, there may come a time where the existing mortgage should be replaced by a new mortgage – a so called mortgage refinancing.

The mortgage industry provides a wide range of mortgage products. That diversity facilitates a good matching of the mortgage terms to the borrower's individual purposes and circumstances. It also makes shopping for a mortgage a confusing and trying experience. The fact that a mortgage is one of the largest single financial commitments a purchaser typically makes does not reduce the stress of the shopping experience.

This note provides a broad background on mortgages. It permits the reader to understand the different types of mortgages and to understand why a particular mortgage is recommended in a given set of circumstances.

2. Types of Mortgages

Mortgages come in two basic types: conventional mortgages and adjustable rate mortgages (usually abbreviated as ARM.) A conventional rate mortgage provides for the borrower to make a fixed monthly payment. That payment represents a combination of repayment of the original loan and of interest payments on the outstanding debt. Most conventional mortgages continue until the original loan is entirely repaid. Some conventional mortgages continue until an intermediate point and then the final "balloon payment" repays whatever is remaining of the loan at that point.

An ARM has a monthly payment where the periodic payment may vary through time. Typically the interest rate on the loan is determined by adding an increment to some well known market interest rate.

Typical market interest rates are the Treasury short term bill rate, the Prime Rate, and the Cost of Funds Index. The increment added reflects the risk taken on by the lender in extending the loan. An ARM may adjust its interest rate every month or at some longer interval such as quarterly or yearly. The monthly payment represents a combination of loan repayment and the varying interest rate on the remaining loan balance. It is quite typical for ARMs to treat the first period differently from the subsequent periods. Two common features are an extended fixed rate period and an interest only period. Thus a 5/1 ARM keeps the initial interest rate fixed for the first five years and thereafter adjusts it once a year. If the first period is interest only then the monthly payment involves only an interest payment with no loan repayment. Typically this reduces the level of payments in the initial period below what they otherwise would have been.

A real property may have more than one mortgage on it. In that case the original mortgage is known as the primary or first mortgage. Subsequent mortgages are known as second and third mortgages. The numbering reflects how the mortgages are paid off. At some point the underlying property is sold. Proceeds are applied first to repaying the first mortgage, then the second mortgage and so on until all mortgages are paid. After all mortgages are paid, the remaining proceeds go to the owner of the property.

The value of the property minus the value of the loans secured by the property is known as the owner's equity in the property. Second and higher mortgages are known as equity loans as they are viewed as being made against the owner's equity in the property.

The lender on an equity loan is said to be in second position if he has made the second mortgage on the property, in third position if he has made the third mortgage and so forth. Most lenders will not accept a position lower than second, although some lenders may extend a third mortgage if they are also the lender on the second. For this reason, mortgages ranked higher than third are rare.

A mortgage may also be secured by more than one property. A mortgage could be a first on one property and a second on another. Generally these types of mortgages are rare. A circumstance where it might arise is if a borrower owns a primary residence purchased with the aid of a purchase money first mortgage. Later he buys a vacation home with the aid of another purchase money mortgage. This mortgage is secured by both properties, taking first position on the vacation home and second position on the primary residence.

A secured line of credit is another type of mortgage. The lender sets a credit cap on the line. Initially the borrower has no borrowing on the line, but later he can take draws against the line until the credit cap is reached. During the drawing period he pays interest only on the amount drawn. He can even take a draw to cover the interest payment so the liquidity impact of the interest payment is deferred. Once the credit cap is reached or a cut-off date is reached, no further draws are permitted against the line. The line then converts to an ordinary mortgage and the borrower commences monthly payments that cover the interest charge and pay the loan down. Secured lines are often second mortgages on the property and thus they are known as equity lines.

There are many uses of secured lines. One use of a secured line is to have a backup source of liquidity. The borrower takes out the loan with no immediate plan of drawing on it. But it is there ready to be used. This could be a useful source of emergency cash, for instance, if the borrower were to lose his job. Meanwhile the cost of the line is just a low annual account maintenance fee. Another case where a secured line would be used is to fund a construction project. Suppose one knows the project will cost $100,000 but it will take six months. You could fund the project with a $100,000 loan initially. But you do not actually need the full $100,000 on the first day. Instead you could set up a $100,000 line and draw on it month by month. Depending on terms, this arrangement could work out cheaper. Also you will be in a better position if there are cost overruns on the project. For a lender to raise a credit cap by an incremental amount is usually a fast low cost action. But if you need to go back to the lender and replace an outstanding loan by a new and bigger loan considerable delay and substantial fees may result. Although there is no real difference in the two cases, lenders have a different mind set about loans and lines. They think of loans as "one-and-done" whereas they see lines as about continuing relationships and flexibility. As a result the internal procedures they adopt for the two types of products may be different.

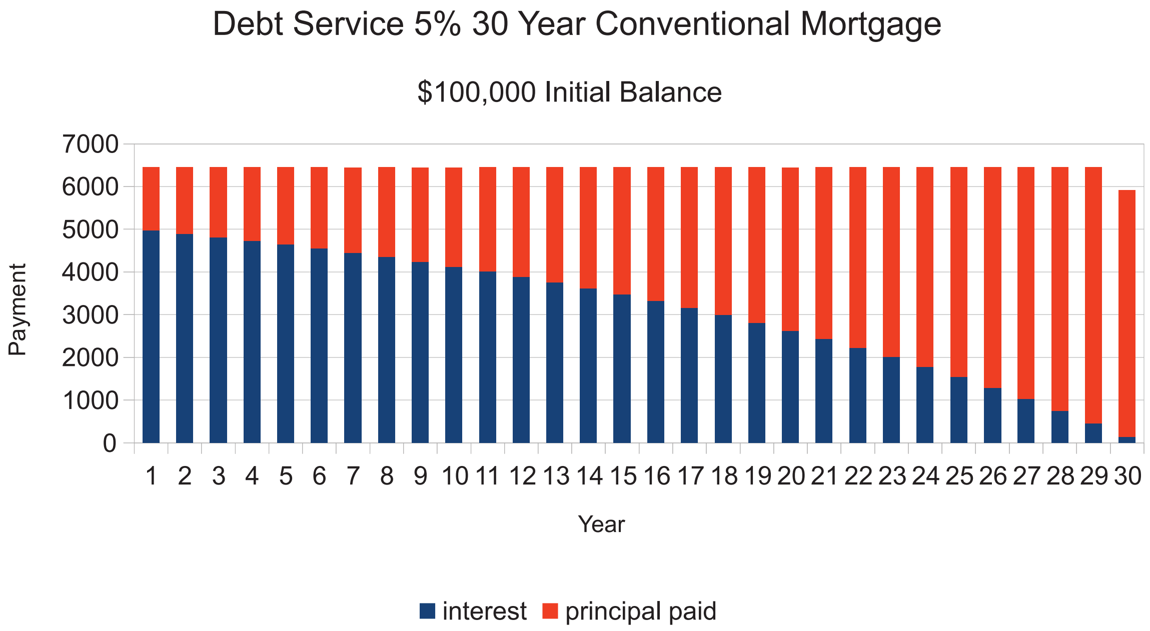
3. The Conventional Mortgage

A conventional mortgage requires the borrower to pay the same amount each month until the loan is paid off. Each payment represents a combination of interest and principal. Initially the payment is mostly interest, but over time the principal payments whittle down the loan balance. As the loan balance declines the interest component of the payment declines and so a larger amount of the monthly payment is available to reduce principal. Thus with a conventional mortgage loan repayment happens slowly at first but accelerates over the life of the loan. Table 1 (next page) illustrates the pattern for a $100,000 loan at an annual interest of 5% for 30 years.

Table 1: Payment Schedule For An Illustrative Fixed Mortgage

year	opening balance	interest	principal paid	total paid	closing balance
1	100,000.00	4,966.32	1,483.20	6,449.52	98,516.80
2	98,516.80	4,890.43	1,559.09	6,449.52	96,957.71
3	96,957.71	4,810.67	1,638.85	6,449.52	95,318.86
4	95,318.86	4,726.82	1,722.70	6,449.52	93,596.16
5	93,596.16	4,638.68	1,810.84	6,449.52	91,785.32
6	91,785.32	4,546.04	1,903.48	6,449.52	89,881.84
7	89,881.84	4,448.65	2,000.87	6,449.52	87,880.97
8	87,880.97	4,346.28	2,103.24	6,449.52	85,777.73
9	85,777.73	4,238.68	2,210.84	6,449.52	83,566.89
10	83,566.89	4,125.57	2,323.95	6,449.52	81,242.94
11	81,242.94	4,006.67	2,442.85	6,449.52	78,800.08
12	78,800.08	3,881.69	2,567.83	6,449.52	76,232.25
13	76,232.25	3,750.31	2,699.21	6,449.52	73,533.05
14	73,533.05	3,612.22	2,837.30	6,449.52	70,695.74
15	70,695.74	3,467.05	2,982.47	6,449.52	67,713.28
16	67,713.28	3,314.47	3,135.05	6,449.52	64,578.22
17	64,578.22	3,154.07	3,295.45	6,449.52	61,282.77
18	61,282.77	2,985.47	3,464.05	6,449.52	57,818.72
19	57,818.72	2,808.24	3,641.28	6,449.52	54,177.45
20	54,177.45	2,621.95	3,827.57	6,449.52	50,349.87
21	50,349.87	2,426.12	4,023.40	6,449.52	46,326.47
22	46,326.47	2,220.28	4,229.24	6,449.52	42,097.23
23	42,097.23	2,003.90	4,445.62	6,449.52	37,651.61
24	37,651.61	1,776.45	4,673.07	6,449.52	32,978.55
25	32,978.55	1,537.37	4,912.15	6,449.52	28,066.40
26	28,066.40	1,286.06	5,163.46	6,449.52	22,902.93
27	22,902.93	1,021.88	5,427.64	6,449.52	17,475.30
28	17,475.30	744.20	5,705.32	6,449.52	11,769.97
29	11,769.97	452.30	5,997.22	6,449.52	5,772.75
30	5,772.75	145.45	5,772.75	5,918.20	0.00

This graph shows the same data.



A borrower using a conventional mortgage has two decisions they must take. First, how much to borrow and second for how long. Market conditions will determine the interest rate that the borrower must pay and thus the monthly payment. The longer the term of the mortgage the more interest the borrower will pay over its life. Thus the borrower who wants to keep borrowing cost low will want a shorter lived mortgage. However, the shorter the life of the mortgage the higher the monthly payment. Generally creditors will only extend credit to the point where the monthly payment is a certain fraction of the borrower's monthly income. Thus, the borrower who wants to maximize how much he can borrow will seek the mortgage with the longer term. For instance, a borrower with a monthly payment capped at $10,000 and a 5% interest rate can borrow up to $1,264,500 on a fifteen year fixed mortgage. The same borrower can borrow up to $1,862.900 on a thirty year fixed mortgage.

An important issue is whether the mortgage is conforming or not. Generally the mortgage is made by one lender who is known as the originator. The originator may keep the mortgage on his books until it is paid off many years later. Or the originator may sell it to an investor and thus free up his capital to make a new loan to someone else. If the mortgage is conforming then it may easily be resold. There is a government sponsored business which buys conforming mortgages from originators, pools different mortgages together and sells interests in the pools to investors. This firm is known as a pool operator. The pool operator guaranties to the purchasers of pool interests that payments on the pool securities will be timely. Thus end investors only need consider the credit standing of the pool operator and not the credit quality of the mortgages in the pool. The major pool operators were formed by the government and operate under its sponsorship in furtherance of public policy. Accordingly the market regards the credit of the pool operators as backed by the government. This arrangement means there is generally a large pool of capital available to fund conforming mortgages, and so such loans are readily available at good rates. At the same time the originator of conforming mortgages can readily resell the mortgages he originates. The originator generally earns fees for originating loans. As a result, he wants to originate as many mortgages as possible and the ability to resell the loan greatly assists him. What this means is that there are normally a good number of originators of conforming mortgages out hawking their loans.

By contrast there is the nonconforming mortgage. Here it is hard or at least harder for the originator to sell the mortgage. The originator may need to keep the loan for its whole life. Finding a lender who is willing to lend on the terms the borrower desires may not be easy. Often the borrower will work with a mortgage broker. The broker knows what sort of terms each lender will consider and he shops the borrower's loan around to the various lenders until he finds one willing to make the loan. With a hard to place loan this shopping process could take weeks, although days is more common. Naturally the broker expects to earn good fees for his service. Between fees and lack of competition to make the loan, nonconforming mortgages will be more expensive than conforming mortgages.

Thus the borrower who wants to keep his borrowing costs low will seek to conform to the criteria required to qualify for a conforming mortgage. These criteria are oriented towards making sure the borrower presents little credit risk. The requirements are

1. The total loan amount should not exceed a size limit.
2. The borrower should have substantial equity in the property.
3. The monthly payment should not exceed a certain fraction of the borrower's monthly income.
4. The borrower should have a good record with prior loans as evidenced by his credit score.

The originator will collect the information from the borrower that addresses these points. The originator's underwriting department will then verify the data and qualify the loan as conforming. Thus the borrower on a conforming mortgage can expect to make lots of disclosures about his personal financial situation and he can expect a one to two week period during which underwriting checks his disclosures before the originator will confirms readiness to make the loan.

Nonconforming mortgages generally violate one or more of the criterion for a conforming mortgage. So called jumbo loans exceed the size limit on conforming mortgages. They are usually taken out by fairly rich people who are buying larger properties. By contrast, starter mortgages cater to young couples who have not built up the savings required for the down payment required with a conforming mortgage. Finally weak/bad credit mortgages usually apply to borrowers who experienced financial stress in the past and who are in the process of rebuilding their financial lives. For each type of nonconformity lenders will look for offsetting elements of strength that counterbalance the issue that makes the mortgage nonconforming. In addition they will generally charge a higher interest rate.

The standard purchase money mortgage is a 30 year conventional mortgage. As the name suggests it is used to purchase a property which normally will be used as the borrower's primary residence. Currently (2024) the conforming limits for a single family detached dwelling are:

1. Maximum loan size of $766,550 unless the property is in a high cost area in which case the limit is $1,148,825. Limits for multi-unit dwellings are higher.

2. Down payment of at least 3% of loan. For equity less than 20% mortgage insurance will be required.

3. Combination of mortgage payments, real estate taxes and fire insurance does not exceed 45% of household income.

4. Credit score of 620+ implying some prior credit history, no significant loan delinquencies in last five years and no excessive levels of debt currently.

5. At least two years of stable employment

4. The Adjustable Rate Mortgage

A conventional mortgage exposes the lender to considerable interest rate risk. Typically the lender is borrowing money itself to fund the mortgage. With a long lived mortgage like a 30 year loan, the lender is locked in to a certain revenue stream for a long time. Over that period the lender's funding cost might rise substantially and put the lender in an unprofitable situation.

The adjustable rate mortgage is a mechanism that allows the lender to transfer some of this risk to the borrower. Periodically the interest rate on a adjustable rate mortgage is reset. A published interest rate is used as the rate base. A constant premium is added to the base to come up with the interest rate the loan carries over the next period. Several commonly used rate bases are the interest rate on US Treasury bills, the interbank loan rate and the cost of funds index. The choice of rate base matters to the lender, but for borrowers the differences between these three rate bases are not too important. ARM mortgages also differ in how often they reset. Popular reset intervals are monthly, quarterly and annual. For borrowers longer reset intervals are generally preferred as it results in more predictability to the household budget. Typically ARMs offer special terms on the first period. The first period may be several years long. It may require only interest payments in the first period. For instance the 5/1 ARM has a five year long first period followed by one year resets. Because an ARM exposes the lender to less risk than the conventional mortgage, the first period interest rate is usually lower than the interest rate on a conventional mortgage. Sometimes it is much lower.

There a couple of different reasons a borrower might prefer an ARM to a conventional mortgage. Almost all of them revolve around the idea that the borrower intends to keep the mortgage for only part of its life:

1. The borrower only intends to own the property for a few years after which the property will be sold and the loan repaid.
2. The borrower thinks interest rates on conventional rate mortgages will be lower in a few years. The borrower intends to refinance out of the ARM and into a conventional mortgage once the conventional mortgage rate comes down.
3. The borrower thinks his credit profile is on an improving trend and in a few years he will be able to borrow with less of a credit risk premium than is the case today.
4. The borrower thinks in a few years he will qualify for a conforming mortgage, e. g. because he has built up enough equity in the property.

Unfortunately this is not why most ARMs are made. Often ARMs are missold to borrowers who cannot handle the embedded interest rate risk. They go into the ARM because of its initial low rate which may also get them into a larger loan than they could qualify for with a conventional mortgage. When rates rise or the initial “teaser rate” in the first period resets to market rates the borrower finds himself in an untenable position. He needs to quickly sell his property. But rising interest rates typically depress property prices. A hurried sale at this point may wipe out the borrower's equity. Reluctant to accept that reality, the borrower tries to hang on. In most cases, however, he cannot and he is forced into a foreclosure or forced sale which strips him of equity and damages his credit rating. These qualities can make ARMs quite dangerous for uninformed borrowers.

Another consequence of an ARM mortgage is to crimp the borrower's credit capacity. Suppose the borrower takes out an ARM primary mortgage and later he wants to take out a second mortgage or an equity line. A lender will evaluate the borrower's financial condition based not on the current interest rate on the ARM but on what the lender judges a realistic maximum rate to be. For instance the current ARM rate might be 4% and the borrower's income might be four times the monthly service charge. With such ratios and an underlying conventional mortgage the borrower would likely be an excellent candidate for a second mortgage. But the lender would likely evaluate the situation on the hypothesis that the ARM rate could rise to 12%. Under those circumstances the borrower's income would barely be covering mortgage service. In most circumstances the lender would refuse to extend the second mortgage. Suppose the borrower absolutely needed the additional credit – for instance to repair storm damage to the property. He would first have to refinance his ARM mortgage into a conventional mortgage. Doing so could require paying high fees and perhaps accepting a higher fixed interest rate than he would like. Only after repairing his credit in this way could he qualify for the additional credit he needs. A borrower's basic reason for entering in to an ARM is to save money. But life is full of unexpected turns and "gotchas" such as described here can cause ARMs to be more expensive than expected.

Let us summarize the discussion. To enter into an ARM you should have considerable financial strength:

1. a secure job or other source of income
2. the capacity to handle a substantial increase in the ARM interest rate
3. substantial liquid assets (cash and securities)
4. be perceived as a top quality credit by lenders

You should also have a settled intention to exit the ARM before the end of the fixed rate period for one of the reasons given above. You should most likely not need to take out a second mortgage on the property. And finally the projected cost saving from the ARM should be substantial. If all these factors are true, then an ARM may be a choice you should consider. But remember the essence of an ARM is that it transfers to you a risk which a bank does not want to take. Generally the bank is smarter about financial risk and better able to manage it than a borrower. If the smarter party in the transaction is trying to tempt you into taking a risk that the smarter party does not want you should be careful.

5. Equity Loans and Lines

An equity loan is just a loan made on a property than already has a primary mortgage on it. A typical situation where that might arise is that the primary mortgage was taken out 10 or 15 years ago. Initially the borrower did not have much equity in the property – say 30%. But over time he has paid down part of the primary mortgage and also the price of the property has gone up. Now the owner has substantial equity in the property, say 60%. Circumstances arise where the owner wants to tap some of that equity through a loan. One possibility would be an "equity out" refinance where the existing primary mortgage would be replaced with a new primary mortgage for a larger amount than the current principal value of the existing mortgage. The increase in the principal value would be paid to the borrower at the time the refinance transaction closes. But it may happen that interest rates have risen since the first mortgage was contracted. Doing an equity out refinance would raise the interest rate on the total borrowing. The alternative course of action is the second mortgage. The primary mortgage is left in place and an additional mortgage is contracted.

Second mortgages have certain characteristics

1. With a first mortgage lenders may lend up to 70% or even 80% of the property value. On a second mortgage lenders are reluctant to loan more than 60% of the borrower's equity (i. e. property value minus current amount owed on the first mortgage.) Most lenders refuse to make third mortgages and those that do will rarely go above 50% of equity (property value minus balances on first and second mortgages.)

2. The interest rate on a second mortgage will be higher than on a first mortgage. A spread of 1 percentage point is typical.

3. The process of qualifying for a second mortgage is faster and simpler than for a first mortgage. Basically the second lender relies on the work done by the first lender. Thus the second lender generally does not pull a title report or investigate the borrower's finances in full depth. Instead they look at the payment history on the first mortgage. If all payments were made on time, then generally they are satisfied. As long as any late payments were sporadic and a matter of just a few days, they will generally assume that is just due to illness and the other disturbances which every life is subject to. But if they see a pattern of late payments, especially if it occurred recently, they will suspect some

financial stress in the borrower's life and may decline to extend the loan.

We described an equity line earlier. The lender establishes a credit limit. The borrower makes draws against the limit. The borrower can draw up to the limit. If the borrower repays part of the loan then the borrower can make further draws until the credit limit is reached again. On a set date the drawing period ends. The line then converts to a straightforward mortgage loan and the borrower pays it off through a series of payments. A typical arrangement might be for the drawing period to last five years and the final payoff period to last fifteen so that the line has a total life of twenty years. Generally the borrower is charged interest only on the amount of the line drawn. Thus one could establish a credit line, draw nothing on it and be charged only a small annual account maintenance fee of say $100. Such a line can function as a standby credit facility to deal with unexpected emergencies or used to finance spending plans which have not yet firmed up (e.g. a home improvement or remodel.)

A second mortgage could be either a conventional mortgage or an ARM. An equity line is usually an ARM. We are quite cautious about using ARMs for first mortgages. Equity lines are typically taken out for smaller amounts than primary mortgages and so the uncertain cost of an ARM is typically less of a financial risk to the borrower. A second mortgage could be for a smaller amount and there too an ARM would not be an excessive risk. Alternately, a second mortgage could push the borrower's credit capacity to the limit and then the additional risk of an ARM must be strictly avoided. There is no hard and fast rule. Each situation should be analyzed on its own merits.

If one needs a second mortgage then one needs it and there is not much else to say. But in general debt should be kept limited and be paid off steadily. A second mortgage moves in the opposite direction and so its not something we want to see people doing as a matter of course. We are more relaxed about equity lines as a standby credit facility. If you have substantial home equity then establishing an equity line can make a lot of sense. There is one situation where such a standby facility can be essential. If you lose your job and are taking a few months to find another job it will generally be impossible at that moment to set up a second mortgage to tap the savings built up in your home. As a result you may be quite pinched paying basic living expenses and might even have to sell your home to avoid going into foreclosure. However, if you have an equity line in place you can draw against it to make mortgage payments and to meet other basic living expenses. Thus a standby credit facility can mean the difference between a major life disruption and a relative non-event. When you have substantial home equity, few savings in the form of cash and securities and you work in an industry or a job function where job security cannot be assumed then an equity line should be a basic part of your financial security package. Alternately, if there are significant savings of liquid assets and/or the household is a two income family the additional security of a stand by credit facility may be less necessary.

6. Hard Money Mortgages

Most purchase money mortgages and equity loans are extended by banks. Banks fund themselves by taking deposits from the public. The government provides guarantees of deposits and so it is motivated to keep banks from engaging in risky lending. Mortgages, because they have long lives, are potentially risky loans to make. As a result the government requires bank generated mortgages to adhere to strong credit standards. The borrower must show sufficient income to service the mortgage. The property must also have good collateral value, but collateral value alone can not substitute for income.

Besides banks, mortgages are also made by finance companies. These companies fund themselves without taking deposits from the public. One way they fund themselves is with equity and proceeds of bond sales. Another way they operate is by selling the mortgages they originate to end investors. Often these end investors are wealthy individuals or investing institutions. The finance companies operate under a different set of regulations than banks. As a result they can extend mortgages in situations where banks cannot. But, by the same token, the finance companies usually avoid loaning money in competition with banks. Basically they are trying to earn higher fees and charge higher interest for dealing with more specialized situations.

The loans made by the nonbank lenders are known as hard money loans. Generally such lenders look primarily to the value of the collateral as backing for the loan and they place less emphasis on the borrower's income level and credit history.

There are a number of standard situations in which hard money loans are utilized:

1. bridge loans – the borrower owns property A and wishes to buy property B. The borrower intends to sell A and use the proceeds to fund the purchase of B. His income level will not permit him to have two bank mortgages at the same time however. So he takes out a hard money loan on B. He then sells A. Now he can apply proceeds from A towards paying off his loan on B and his income is freed up so he will qualify for a bank loan to refinance whatever balance remains on his hard money loan. In the case where A is his primary residence a bridge loan is much less disruptive than first selling A, living in rented quarters for some time and then buying B. With a bridge loan the home owner can buy his new home, perhaps do some construction work on it while he continues to live in A and then move into B when everything is ready. Particularly when there is a family with young children or seniors involved this smoother transition may be very worthwhile.

2. the fast purchase – Some property has just come on the market. The property is uniquely attractive to the purchaser. Perhaps its location or physical qualities are of special importance to the purchaser. Were the purchaser to miss buying this property perhaps he cannot find a replacement that is as suitable to his needs. To be sure of getting the property the purchaser would like to make an all cash offer for the asking price. But putting together a conventional bank mortgage and associated offer may take several weeks during which period the purchaser fears he will lose the property. In this situation a hard money lender may be able to close quickly. As long as the purchaser can bring in some other assets, either in the form of liquid savings or an already owned property with equity, the hard money lender is likely to view the total package of collateral constituted by the to-be purchased property and the outside assets as meeting his lending criteria. The hard money lender is set up to handle these fast close situations and may be able to close within 3-5 days. After the purchaser closes using the hard money funds he can set up a conventional financing structure in an unhurried manner.

3. business purpose loans – the borrower owns a small business and wants to borrow money to build up the business. The business does not yet have a long enough or strong enough operating history to qualify for the loan on its own. For some reason the borrower does not qualify for a second mortgage bank loan. The borrower can take out a hard money second mortgage on his primary residence and use it to fund his business. These loans are known as business purpose loans. They are one of just a few situations where hard money lenders will lend against property occupied by the borrower.

4. developer loans – the borrower is in the business of buying properties, fixing them up and reselling them at a profit. Typically the buyer puts down 50% of the purchase price and the hard money lender supplies the balance. If the developer has a strong track record, the lender may supply even more of the purchase price. Basically the lender is providing financing to the developer's business.

5. foreclosure rescue loans – the borrower has a mortgage and something has gone wrong with his plan for servicing it. He needs temporary financing while he fixes this problem or sells the property. A hard money lender may either take over the first mortgage or supply financing in the form of a second.

6. rental property loans – the purchaser is buying a property to rent it out. Once a good rental history is established the property will qualify for a bank loan. But for the moment the rental history is weak or nonexistent and the property will not qualify. The hard money lender provides financing while the purchaser works to get the property on a good operating basis.

The common quality to all these situations is that the borrower needs money on a short to medium term basis and he does not plan on servicing the mortgage until the loan is paid off. The terms on a hard money loan are adapted to this situation. Such mortgages have maturity dates one to five years in the future with three years being quite typical. Often the loan is interest only so no principal is paid down over the life of the loan. At maturity a large balloon payment is due which covers any loan principal not paid off by monthly service. This could potentially be the entire initial value of the loan. Because the borrower is a weaker credit than the standard borrower on a bank mortgage, the interest rate will be higher. It could be three to five percentage points higher on a first mortgage and even more on a second mortgage. Hard money lenders have a lot of flexibility as to who they can loan to and with what structure but this flexibility comes at a high cost.

The world of hard money loans is quite different from regular bank mortgages. Most borrowers access this market through mortgage brokers. Not all mortgage brokers are active in hard money lending. The brokers for hard money loans tend to be specialists for this type of lending. They know the different firms that make hard money loans and understand their operating characteristics: what types of loans they make, what their lending standards are and what terms they require. This knowledge allows the mortgage broker to shop the borrower's situation effectively. Once a potential lender has been located the approval process can vary a lot from firm to firm. If the firm is using its own money to extend the credit then it may offer a very quick close. If the firm is originating mortgages that it resells to investors the process may take longer. The firm will have a list of investors it works with. It will expose the deal to its list. It may have to form a consortium to take up the loan if no one investor is looking to invest the full amount. It may have to wait for investors to transfer in funds and that can be contingent on some other deal first paying off as scheduled. The whole process of gathering funds could take a month or more. Again the mortgage broker's knowledge of the funding firm is essential as that allows them to distinguish situations where the firm is truly committed to the loan and simply taking its time with the back office process from the firm which may be stringing the borrower along with warm talk but no actual commitment while it sorts out if it really wants this deal or not. In other words, the hard money loan market is really a wholesale market in which consumers sometimes participate rather than a retail market with all the protections and protocols that implies.

Readers of this note may also at times be end investors who invest in the loans originated by this process. Hard money loans have certain characteristics. First the borrowers typically have real assets but challenged cash flows. The investor should expect the loan to get repaid but should also expect hiccups along the way. It is not unusual for scheduled payments to happen late. Second it is quite important that the loan origination process was done correctly and all legal niceties were observed. Working with an experienced originator with a good track record is important.

Some of the lenders active in the hard money market are somewhat predatory. Their aim is to drain the borrower of liquidity through exorbitant late fees and force him into either selling his collateral or losing it in a foreclosure. Borrowers protect themselves primarily by only agreeing to terms which they can keep. Of particular importance is the large balloon payment at the end of the hard money loan. Generally the borrower intends to meet that payment through a new loan. He should begin looking for the replacement loan up to 12 months ahead of the scheduled maturity. That way, if a replacement loan can not be negotiated, he still has time to sell the underlying property in an orderly manner and thus preserve his substantial equity. Thus a hard money loan for 18 months is actually only a loan for just 6 to 9 months. It probably carries closing fees of 2% to 5% which is truly exorbitant for a short term credit.

7. Mortgage Defaults

What happens if you cannot meet the terms of the mortgage? The answer depends on whether this is a bank loan on an owner occupied property or whether it is something else, either not an owner occupied property or not a bank loan. In the former case law and regulation prescribes a detailed protocol. In the later case things are more free form. For the owner occupied property bank loan the protocol is as follows:

1. A payment can be up to 10 days late without consequences. After the tenth day a late fee is typically added to the monthly payment.

2. Once the payment is 30 days late the event will be reported to a credit bureau and will reduce your credit score.

3. Once a payment is 60 days late you will receive a warning that you could be put into foreclosure. A notice of default may be filed which gives public notice of the situation. If you try to sell the property after the notice of default is filed buyers will know that it is a pressured sale and they will likely offer you lower purchase prices.

4. After you are 90 days late you will likely hear from the lender's law firm. They will inform you that you have until a certain date to catch up on all payments and late fees. Doing so is known as curing the default. It is your right to cure up to about 110 days after the original late payment. If you cure then the whole episode is at an end and you reset to as if the default never happened (except that it will remain part of your credit record.)

5. If you fail to cure then once the 120 day point is reached the lender files a foreclosure action. During the foreclosure you continue to have the right to cure or sell the property but you are definitely running out of time and under pressure.

6. About 20 date after starting the foreclosure the lender can set an auction date which will be about 10 days out. Your right to cure ends about 5 days before the auction date. However you can still stop the auction by repaying the loan in full up to the day before the auction. Generally that repayment is made either by closing the sale of the property or by closing a replacement mortgage.

7. An auction of the property will typically result in just enough money to pay the lender on the first mortgage. The owner of the property will lose whatever equity he had in the property. If there is a second mortgage holder they also will be wiped out. To avoid this situation the second mortgage holder may intervene, either by extending further credit to cure the default or by buying at auction. Auction terminates the borrower's ownership of the property.

8. How long the borrower may continue to reside at the property depends on who the purchaser at auction was. If the purchaser intends to occupy the property themselves they can require the former owner to move out within 30 days. If, as usually is the case, the property was purchased by a dealer in distressed properties then the former owner may have up to 60 days to move out. Depending on market conditions, the individual purchaser and other factors, the former owner may be able to enter into a rental agreement that allows him to stay longer. However that is not common.

To summarize, from the moment of first default until termination of residency is anywhere from 6 to 9 months. However, the time to fully protect your equity is much less. Equity gets eroded either by selling under pressure or by exorbitant late fees and refinance charges. Generally the event that made you late in the first place did not come out of the blue – there was some warning. The moment you realize that you might be late you need to assess – is this a truly temporary matter that will get fixed in two months or is there a structural problem. Form an appropriate plan and have a contingency plan in case your first plan fails. For instance the problem might be you lost your job. You know you can cover the next interest payment out of savings but not the subsequent ones. So your primary plan is to get a new job. If you can do that within 60 days you are ok. But if not, selling the property is your contingency plan. Think both plans through in detail. Set a date for switching plans. Thus you might set a date 40 days out. If a new job is not coming together at that point then you switch to the contingency plan on this date. In any case do not let the situation slide on wishful thinking. Wishful thinking is the road to disaster.

At some point it will become clear to you that you are unlikely to cure the default before the 90 day deadline. This is the point where you need legal advice. An experienced attorney who specializes in mortgage default situations can do a lot for you. Lenders are reluctant to push loans into foreclosure. Many offer work out programs. For instance they may agree to interest only payments for a period of time and thus reduce the immediate monthly payment to something you can handle. Alternately they can agree to extend deadlines so you can sell the property in an orderly manner that preserves your equity. Finally a hard money lender or a second mortgage lender may step in to salvage the situation if the circumstances fit their criteria. An experienced attorney will know how to navigate through the complex set of choices you face to get the outcome you want at least cost for you. Unfortunately you are a bad credit and so the attorney will want his fees paid in advance. Engage a good attorney before you have been drained of cash. Once you are out of cash you have lost control of the situation and outcomes will be somewhere between painful and awful.

If the loan is something other than a bank loan on owner occupied property the process will be similar but it will move faster with fewer opportunities to cure. Take action even sooner. If you are dealing with a hard money lender engage an attorney the moment you know this is more than a one time issue. Hard money lenders have more flexibility than banks and can really work with you to solve problems, but they also can charge the moon and are aggressive in protecting their own interests. Unfortunately lenders of all types can lie to distressed borrowers. They claim to be qualifying you for a loan modification while actually they are letting deadlines run out so they can slate you for auction. A tip off for this situation is the sympathetic rep who really wants to help you but faces an obstacle from a nameless person in underwriting, compliance or some other vague department who is demanding “just one more piece of paper.” A good attorney is protection against this sort of abuse.

If you go into foreclosure (not even going to auction) that fact will remain in your credit record for seven years. It will cost you higher fees on any new loan you take out and it will limit your ability to borrow. Make every effort to avoid it.

Losing ones personal residence through forced sale or auction is a major life trauma. Make every effort to avoid it. The most important step is to avoid getting into a mortgage you cannot handle in the first place. Borrowing too much, using an ARM in the wrong circumstances, drawing out too much equity through second mortgages or lines and failing to keep an adequate emergency fund are all ways to get yourself in trouble. The most common way people lose their home is an extended illness which hits them with high care bills and causes them to lose employment for an extended period. This illness might happen to someone you need to care for rather than happen directly to you. Carrying good medical and disability insurance can provide substantial protection against this situation.

Lending laws vary from state to state. What we have described here is the general pattern but your state may differ – particularly in terms of how long each stage takes. Make sure you are correctly informed about the process at it applies in your state. Also be aware that there are quirky state rules that may help certain classes of persons. e. g. military deployed abroad, veterans and seniors.

8. Selecting A Mortgage

The mortgage market provides lots of choice. It is easy to get overwhelmed. The solution is to focus first on the standard solution for your situation. Once you know the default answer you can look to see if there is an alternative to consider.

The most common use of a mortgage is to buy a property, usually as a personal residence. The default purchase money mortgage is a thirty year conventional mortgage. If possible seek to make this a conforming loan. If a large down payment is possible or income is strong a faster payoff (e.g. a 15 or 20 year mortgage) can provide significant savings. In specific circumstances an ARM can be worth considering.

An equity line can be a useful back up source of liquidity, especially if you have substantial equity but limited liquid savings. However, it requires substantial self control to avoid accessing this credit to support a spending spree. If you tend to max out credit cards and carry expensive balances you probably should avoid opening an equity line.

A second mortgage can mobilize savings for capital projects such as improving the property or sending a child to college. Normally a conventional mortgage will be your first choice. But if the amount borrowed is small an ARM may save money without exposing you to excessive risk.

Hard money loans can provide short to medium term credit at a high price. They are suitable for highly specific situations. In those situations they deliver a lot of value which justifies their higher cost.

9. Applying For A Mortgage

The starting point for getting a mortgage will either be your bank or a mortgage broker. If you are thinking of buying a home and want to know what your borrowing capacity will be, then your bank will be where you start. If you are looking for an equity loan or line, then also your bank would be your starting point. If you know you are looking for a large loan, a hard money loan or you are a complicated credit then you should probably start with a mortgage broker. Also if you have heard what your bank can do for you and it is not satisfactory, it may be time to talk to a mortgage broker. Brokers vary. Often they specialize in a certain type of mortgage. Go to the broker who handles situations like yours all the time. If you have borrowed from a lender in the past and there were no problems, you can ask them again. But normally one does not approach a lender cold with whom one has no prior relationship – one goes through a broker instead.

The application process goes in three stages:

1) You work with a mortgage broker or a loan officer to identify the type of mortgage you want and what your basic credit profile is. You fill out a loan application. The broker will present this to several lenders looking for the best deal. A loan officer will forward the application to underwriting.

2) A lender expresses interest in making the loan. You will be asked for documents that verify the disclosures on your application. Underwriting departments often have complex rules in this regard, e. g. salary may be verified by an annual tax statement plus the most recent month's paystub or by three recent pay stubs. As a result there may be a back and forth with them as they reject certain document submissions or demand further details. Foolish details such as documents in an alternate form of your name may require you to submit an additional document establishing this is really you and not a stranger with a similar name.

3) The loan application is approved and the loan goes into the

closing process. At this point a title company may be asked to issue a title insurance validating a preliminary title report. The title company will normally handle the closing process. You should receive the mortgage documents the day before signing so that you have time to review them. Then you meet with a notary and sign the documents. Some states give you three days to revoke your signature, in which case you may first receive documents at signing. After the signing package is complete it is sent to the lender for review. Sometimes they find a needed signature was skipped and they send the package back to be signed again. After the lender approves the documents they wire funds to the escrow account the title company has set up. The escrow officer will send payments to all the people who get paid ahead of you from escrow, e. g. the mortgage broker, title company, possibly another lender or the seller of the property. Once everything is paid and the transaction is complete, the escrow officer releases the balance of the loan, if any, to you. Alternately, for a purchase money mortgage they deliver the property deed and keys. At this point the transaction is complete.

Each stage of this process typically takes 5 to 10 days. So the entire process can take anywhere between three and six weeks. The length of time involved in the closing process is easy to underestimate. Closing has to be done exactly accurately and all sorts of stupid glitches seem to happen. These glitches may exhibit in the form of unaccountable delays or you may learn specifically about them (e. g. some document got left out of the closing package.) In any case, do not assume a closing will run like clockwork. Be ready to handle the situation where closing takes a few days longer than whatever the lender's representative said was the worst case scenario. This can be especially nerve wracking if you need to close the transaction on time to avoid auction of your property. Do not get into that situation.

10. Refinancing A Mortgage

A mortgage refinance is when you replace an existing mortgage with a new mortgage. There are several situations in which this occurs. In a rate refinance you replace the existing mortgage by one with a lower interest rate, so reducing the monthly payment. In a rate and term refinance you replace a high interest rate mortgage with a lower interest rate mortgage and you also shorten the term of the mortgage. As a result the monthly payment stays about the same but the mortgage is paid off faster and at lower total cost. In an equity out refinance the existing mortgage is replaced with one that has a higher principal value. Such a refinance is an alternative to taking out a second mortgage. It could involve a change in rate (up or down) or term (extended or reduced) but it need not. In a structure refinance one replaces one type of mortgage with another, for instance replacing an ARM with a conventional mortgage. Similarly replacing a hard money medium term loan with a large balloon payment with a conventional long term mortgage could be described as a structural refinance.

The first two refinances reduce the borrowers cost. It is quite advantageous to make these types of refinancings if the cost saving exceed the fees payable in the transaction. Two conditions are necessary for this type of refinance. First interest rates on mortgages must have declined from the time the original mortgage was contracted. Second the borrower's credit rating must be strong enough that a lender will make the desired replacement loan. Keeping open the possibility of doing a cost reduction refinance is a good incentive for borrowers to maintain or improve their credit rating even after they have secured their primary mortgage.

The second two types of refinance do not require a change in market rates for the transaction to make sense. But they still require a good credit rating for them to be possible.

Sometimes one has a first and second mortgage and one seeks to refinance just the first mortgage. Often the second mortgage holder needs to consent to this transaction. For rate and rate and term refinances the second mortgage holder typically grants approval because such refinances improves the borrowers credit standing and thus benefits the second mortgage holder. For other refinances, the second mortgage holder will evaluate the proposition on its own merits. Provided the second mortgage retains at least the credit quality it possessed when first contracted, the second mortgage holder may grant consent. However, lenders vary one from another and consent cannot be assumed. As a result it needs to be verified early on in the refinance process. In situations where the second mortgage holder will not consent, a debt consolidation as described below may be a mechanism that allows the desired refinance transaction to be done.

11. Debt Consolidation

Suppose one has an existing debt and one takes out a new mortgage. Often it is possible to negotiate the size of the new mortgage such that it will both meet the principal purpose of the mortgage and pay-off the existing debt. In essence the existing debt is folded into the new mortgage and so one ends up with one debt rather than two. Such an operation is known as a debt consolidation. Again there are two situations where this operation typically occurs. First the existing debt is an unsecured debt such as a credit card loan or it is a secured installment debt such as a car loan. Typically such debts are much smaller than the mortgage debt, so they change the principal amount of the mortgage very little. Typically also such debts have higher, often much higher, interest rates than mortgage debt. Basically the mortgage is backed by superior collateral and it is often issued through a more exacting underwriting process and so the superior credit standing of the debt results in it being issued at lower cost. Also the lender's administrative costs of a mortgage are spread across a larger amount of principal and so the rate that recaptures these costs can be lower. The second typical situation of debt consolidation is when an existing first and second mortgage are refinanced into one new first mortgage. Here it is the second mortgage which is being consolidated into the new first. Second mortgages always have higher interest rates than first mortgages, so such a consolidation may reduce borrowing costs unless the existing second was contracted at a much lower rate than currently prevails.

Lenders realize that debt consolidation can improve the borrower's credit standing. Basically before consolidation at least two lenders had a claim on the borrower's assets and cash flow, while afterwards the mortgage lender has these resources all to himself. As a result lenders are generally supportive of a borrower's desire to do a debt consolidation. For instance, on a purchase money mortgage they might be unwilling to increase a borrower's credit limit to buy a larger property but they would increase it for the purpose of debt consolidation. What might cause them concern, however, is if a large credit card balance is consolidated and then the borrower immediately rushes out and contracts another large credit card debt. In other words, lenders may need persuading that the debt consolidation is being made for the right reasons (to reduce the borrowers cost and improve his credit profile) and not simply to feed a borrowing frenzy. Thus lenders can usually be assumed open to a debt consolidation but each situation will be looked at on its own merits rather than given blanket approval.

Generally the consent of the existing lender is not required to make a debt consolidation. The exception would be loans that provide a prepayment penalty for early retirement. Such terms are often included in hard money loans to ensure enough months of payments are collected to defray the lender's internal origination costs. Penalty periods seldom extend beyond one year from the time of origination. Pre-payment penalties do not forbid you repaying the loan early. They simply make it more costly. During the process of negotiating terms on a mortgage borrowers should be careful to avoid prepayment penalties which they are actually likely to trigger.

12. Minor Issues

There are several minor issues which come up in the negotiation of mortgages.

Rate locks – You are about to go house shopping. You start by going to a lender and determining your credit limit. The lender says “I will lend you X based on current interest rates.” You start shopping. After several months you find a property you want to buy. You return to the lender to initiate the mortgage application. The lender tells you rates have risen and as a result he can only qualify you for a loan of less than X. As a result your purchase transaction fails. To avoid this vexing situation the lender may offer you a rate lock. In exchange for a payment, he guarantees that any mortgage made over some short time period (1 to 3 months) will be made for a rate no higher than the current interest rate and thus in an amount of at least X. Rate locks are primarily useful for borrowers operating at the limit of their credit capacity.

Mortgage Insurance – Typically lenders want the purchaser of a property to make a down payment which creates 20%-30% equity in the property. However, lenders realize that first time home buyers may have difficulty coming up with so much capital. Accordingly, they may accept a lower equity percentage, even down to 5%. To help offset the risk this creates for the lender the lender may require the borrower to purchase mortgage insurance. The lender is the beneficiary of this insurance and it compensates him in case the borrower dies, skips a few payments or otherwise fails to carry out the terms of the mortgage. Mortgage insurance is pure cost to the borrower with no benefit to him other than making the transaction possible. Accordingly the borrower would like to eliminate this cost item. Typically the borrower's equity will increase as a consequence of paying off the mortgage and appreciation in the property's price. If the borrower has a good record of timely payments and his equity exceeds the usual standard then he can usually eliminate the requirement for carrying mortgage insurance.

Property Insurance – Property insurance compensates you for damage or destruction of any structures erected on your property. Property insurance may contain exclusions for damage due to rare but catastrophic natural disasters such as flood and earthquake. Separate flood and earthquake policies must usually be purchased to cover those situations. Lenders typically require you to carry property insurance with at least as much coverage as their loan amount. Suppose an insured event occurs which leads to a payout from the insurance company of funds to repair the damage. Typically those funds will be paid to the lender and the lender will disburse them in tranches to make the repairs. This can lead to an unfortunate situation for the home owner where the contractor refuses to proceed with a repair until he gets a progress payment and the lender will not disburse funds until their inspector reports some milestone of the project to have been achieved. Such a situation can require the borrower to use personal savings to repair the property and he will only recover the savings from eventual disbursement of insurance funds at the end of the project. The result can be substantial delay in completing the project and higher total cost due to the delay. To avoid this situation it is important to work with a contractor who is familiar with lender controlled repair projects and who will coordinate his billing points to the lender's inspection points. Such contractors often charge more and that fact should be allowed for in settling the damage claim with the insurer.

If the homeowner is required to maintain property insurance but fails to do so, then the lender will put in place "lender forced insurance." This insurance pays only the lender in case of damage and it typically costs a lot. The lender will bill the cost of insurance to the borrower. The borrower should avoid this miserable situation by staying on top of his insurance situation and making sure it is timely renewed each year and coverage gaps do not open up.

Property Taxes – Generally property is taxed by local governments based on appraised value. This tax claim ranks ahead of mortgage claims in distributing funds generated by a foreclosure sale. As a result, lenders require borrowers to make timely payment of taxes. Typically taxes are due every six months. If the borrower is a weak credit the lender will require the borrower to make a monthly installment payment of taxes to the lender. The lender holds these funds apart in an escrow fund and uses them to pay taxes when due. Although this arrangement has a certain convenience for the borrower, it is also holds his cash flows to a tighter schedule and robs him of a degree of flexibility. As a result stronger borrowers usually prefer to retain direct payment of their tax liabilities.

Technical Default – If a borrower is required to make insurance and/or tax payments and fails to do so that circumstance can put him in default even if all his mortgage payments have been timely. In extreme circumstances a technical default could even lead to a foreclosure. Borrowers need to treat these requirements with the same seriousness as the monthly payment.

Points – in the process of closing a loan the lender may offer more attractive terms in return for an upfront payment. Typically the payment is stated as some number of percentage points of the loan value, so such payments are known as points. For instance in exchange for a two point payment the lender might offer to reduce the interest payment by a quarter percent. If the loan is held for more than eight years then the borrower could experience some net cost saving. But if the borrower refinances within eight years he may not fully earn his points back. The lender prices points based on typical borrower behavior or to incentivize some desired borrower behavior (e. g. deferring a refinance.) If the borrower knows his plans are likely to make the point transaction profitable to himself then he should accept it. But if his plans are not so cast iron, the borrower should realize the lender is probably better informed than himself and the transaction is probably not going to be substantially beneficial to the borrower.

Recourse – a mortgage is said to be nonrecourse if the lender can only recover a default from the mortgaged asset. The mortgage has recourse if the lender can sue the borrower and seek recovery from his nonmortgaged assets as well. Persons who invest in real estate, either by developing or improving property or by buying property to rent out will often wish their mortgages to be nonrecourse. Lenders of course have the opposite desire and this issue must be negotiated between them. Persons buying a primary residence usually have few tangible assets other than the property and so the issue of recourse is not important either to them or to their lender.

Assumable – A mortgage is assumable if the borrower can sell or transfer the property and the purchaser can take over the mortgage in place. Lenders do not like mortgages to be assumable and they usually require a transfer of ownership to force repayment of the mortgage. However, public policy may require mortgages to be assumable, if not in general, at least in specific circumstances. For instance transfers which occur by operation of law (e. g. transfer to a spouse due to death of the owner or divorce) may require the mortgage to be assumable. A mortgage which is assumable in general can become a source of value to the borrower if mortgage rates rise and the mortgage in place is for a lower rate than a new purchaser could get in the marketplace. Some jurisdictions feel this “windfall” should accrue to the borrower and not the lender and so they require mortgages to be assumable. Other jurisdictions feel that requiring mortgages to be assumable pushes up borrowing costs and so they do not seek to allocate this windfall to borrowers.

Credit Squeezes – New mortgages can be contracted by high quality borrowers almost all the time. From time to time, however, credit squeezes occur. During a credit squeeze it may be impossible to enter into a new mortgage no matter how strong ones credit is. Generally squeezes develop suddenly with little warning and last one to two quarters. A key implication is that if one is in a situation where a mortgage needs to be contracted or refinanced in the near future one should start the process well ahead of time to avoid getting caught in a squeeze.

13. Tax Issues

It is public policy to encourage home ownership. This encouragement is made through guarantees extended on conforming mortgages and through tax benefits for borrowers. Here we discuss tax benefits. Borrowers are allowed to take mortgage interest payments as a deduction on their Federal income tax return. In effect, the interest payment is made from pretax income. The monthly mortgage payment will usually consist of multiple components – interest, principal, possibly mortgage or lender force insurance and possibly tax escrow payments. Only the interest component is deductible. The amount of the interest payment will go down as the loan is reduced by principal payments, so the tax effect will be strongest in the early years of the mortgage.

The tax benefit is limited. Only interest on the first $1,000,000 of loan value for a first mortgage on a primary residence can be deducted. Also interest on the first $100,000 of loan value on a second mortgage where the proceeds were used to improve the property can be deducted. In some instances debt on a secondary residence may result in a deductible interest payment. Generally lenders send borrowers a statement early in the year showing how much deductible interest was paid in the prior year. Note that interest can only be deducted if paid. A deduction is not allowed on interest which is accrued but as yet unpaid (e. g.

because the borrower is late with his payment.) Thus maximizing tax benefit requires timely payment and possibly accelerated payment of interest due in January.

Borrowers with substantial assets, high income and lots of financial flexibility may wish to evaluate the tax benefit in structuring their mortgage. Often such borrowers could make a larger down payment, but they choose not to so that the mortgage is made to maximize the tax benefit. For the same reason they might prefer an ARM with an interest only initial period as they do not want to reduce the tax benefit by quick payoff of their mortgage. These situations require careful detailed analysis to know what mortgage structure has the best value for the borrower. It is also requires good judgment about risks and the value of financial flexibility for the borrower.

If a mortgage is taken out to acquire a rental property or other investment property the entire interest payment may be deductible as a business expense. Passive loss rules, however, may mean that only part of the interest can be deducted currently. Unused interest deduction is booked and may be deductible against any gain realized when the property is sold. Again understanding the details of the situation are essential to a correct analysis. When the property is mixed use (either a time share or an owner occupied multiple unit dwelling) then the tax treatment will be a mix of the residential rules and the investment property rules. Yet again careful analysis is needed.

Debt forgiveness occurs when a lender releases a borrower from part of his debt obligation. Loan forgiveness occurs in the course of loan modifications or negotiated sales that occur during foreclosures as a way of avoiding an auction. The tax collector generally considers loan forgiveness to be taxable income to the borrower. This can be an evil consequence for a borrower struggling with debt and potentially in the process of losing much of his savings. Often a taxable event can be avoided by properly structuring the modification or sale. If the borrower is working with an attorney, the attorney might be aware of this aspect of the situation. Or he might not. Attorneys can be very ignorant about taxes. In such situations the borrower should consult a CPA as well. Ironically, going broke can be a costly process.

14. Summary

Mortgages are both simple and complex. A conventional purchase money mortgage is simplicity itself. One pays the required down payment and makes equal monthly payments for 30 years. At the end one owns the property outright. Along the way one got some tax benefits, which probably helped make the mortgage affordable in its early years and which did not matter much thereafter. Or one can start out with the wrong mortgage initially, go through several costly refinance operations, finally get into financial difficulties and learn all the miserable details of foreclosures. There is a lot to be said for keeping mortgages simple and safe.

This note is focused on mortgages on owner occupied property. We only skim the surface of mortgages used to support business activities. Real estate investors, in particular, need to know more. They should acquire a deep and substantial knowledge about the mortgages relevant to their business activity. Those details will be essential to their success.