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Asking a Rich Stranger for a Home Loan!

November 30, 2012 – The idea of taking out a high-dollar mortgage from a complete stranger conjures up images of loan sharks and broken kneecaps. But the practice is legal—and on the rise.

Individual investors looking for higher returns are increasingly lending their own money to people who can't or don't want to borrow money from a bank. In most cases, the investor pairs up with a private, nonbank lender who provides the mortgage at rates that often range anywhere from 6% to 13%.

Many of these loans are targeted at a small group of high-net-worth borrowers who look risky to traditional lenders because they prefer not to provide income documentation or because they're self-employed and recently had a down year. In other cases, they might need temporary funding until an expected bonus or other payout comes through or might want the loan faster than a bank can provide it.

These borrowers still seem like a relatively low-risk proposition to individual investors. In most cases, they are required to have high credit scores and to make large down payments, typically at least 30% to 40%. With significant equity in the home, experts say borrowers will be less willing to walk away from it if, say, its value were to drop. Also, if borrowers stop paying their mortgage, lenders can sell the home and use the proceeds from the sale to return investors' money. "The return relative to risk is about as good as it gets," says David Dent, vice president at Certis Capital Management in Santa Barbara, Calif., which has invested about $20 million of several clients' funds with private lenders. To find these lenders, mortgage brokers are a good place to start. They pull quotes from all types of lenders, including individual investors, says Keith Gumbinger, a vice president at mortgage-info website HSH.com. But borrowers should review the terms closely before signing on the dotted line. These loans can come with high interest rates and fees, so the borrower needs to consider whether paying more is worth it to get the loan. While some of these lenders offer traditional 15- and 30-year repayment periods, loan terms may vary. Borrowers may be offered shorter repayment periods, which make their monthly mortgage payments bigger, or a loan with a balloon structure, which requires the borrower to pay the remaining balance after a few years or to refinance.

Private loans have been around for a while, but they have been picking up in the past two years as tight credit conditions continue to shut out potential buyers from getting a traditional mortgage. For instance, Rama Capital Partners in Calabasas Hills, Calif., receives funding from 138 investors to collectively fund all of the mortgages arranged by its partner company, Athas Capital Group. That figure is up 409% from two years ago. Experts say that's partly because more investors are looking for opportunities that provide greater returns.

That's why Neil Chudgar of Los Angeles took the plunge. Mr. Chudgar, a portfolio manager at an investment-management firm, says he grew tired of sitting on low-yielding cash and Treasurys, so he began investing a portion of his nest egg in mortgages in 2009 and has been adding more

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funds each year since.

"On a relative basis, it's become even more attractive," he says.

There are two common strategies for investing in mortgages. Lenders like Aspire Financial in Dallas will pair an investor with one particular borrower. The investor will meet with the borrower to determine whether to lend to him or her and the investor's returns will depend on how that mortgage performs.

A separate model involves pooling many investors' funds together. That's the case at Rama Capital Partners, where investors all get the same return—the company says that has been over 10% for each of the past four years—but have no say in which borrowers get the mortgages.

Investors contemplating either approach should consider a few things:

• **How is your return calculated?** The lenders at the center of this arrangement usually take a cut before repayments on the loans are distributed. In some cases, it's a broker fee of around 1% of the mortgage amount. In other cases, there are annual management and servicing fees of roughly 1% and 0.5%, respectively, on the amount an individual invests. Separately, the interest rate borrowers pay could be below the double-digit range if they decide to pay points, which are optional fees borrowers can pay up front in order to obtain a lower interest rate.

• **What states is the lender working in?** In some states, including Arizona, California and Nevada, a lender can proceed with a foreclosure without court approval. For investors, that means a quicker turnaround between the time the borrower stops paying the mortgage and when they can recover their money. In states where court approval is required, this process can take years, increasing the chances that investors will lose money. Some lenders work nationally but limit the amount they lend in the latter group of states.

• **There are no guarantees.** Investors aren't given any guarantees that they'll recoup their money or earn a return. Should foreclosures spike among the borrowers they're working with, investors could lose their money.