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RESEARCH REPORT:

The *7 Biggest Dangers* when Investing in Mortgages & Trust Deeds and what you must know to protect your Investments Today!

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“The 7 biggest dangers when investing in mortgages and what you must know to protect your investments today!”

Okay, first the 7 Dangers you should never make:

(1) Never close a loan without title insurance or without a up to date hazard insurance policy in effect listing you or your entity as loss payee.

(2) Never close a loan leaving property taxes unpaid and we recommend if the borrower is behind on taxes at the time of the loan you should escrow 1/12 of taxes each month and collect with monthly payment.

(3) Never lend on property for which labor and/or materials have been provided within 90 days prior to closing without either (a) having an extended ALTA policy of title insurance with no exception for labor and materials liens (difficult to get), or (b) having received a signed affidavit from the borrower which lists all providers used (along with contact info and the amount of any outstanding debt), and contacting all labor and materials providers on the list to make sure that none is preparing to file labor or materials liens.

(4) Never close a loan secured by property which appears to show (by inspection, general observation, public record, or known history) a reasonable possibility of being contaminated by any form of hazardous waste, unless you have seen a current level I or level II environmental study showing the property to be clean.

And in any event, always require borrowers to sign a hazardous waste indemnity agreement.

(5) On a construction, rehab, or development loan: never disburse funds for work that has not been completed (unless as a deposit to a company that has been carefully checked out and is considered to be highly credible) and never disburse funds directly to the borrower unless as reimbursement for work that has already been completed and paid for, and which is documented accordingly.

(6) Never lend 100% of purchase price and repairs, this leaves you lending to borrower with no skin in the game. If the property does not sell or renter stops paying you could be left having to foreclose. Now the borrower will tell you the loan to value is 65% so you have plenty of equity in case of default. This maybe true but if you add in the cost and time of foreclosing and the discount you may need to offer to sell property quickly. You could break even or possibly lose principal. Our belief is that the borrowers must have skin in the project at all times we are lending to them.

(7) Never send monies to loan officer, mortgage broker or real estate agent for loan closing. All loans must close at title or escrow company and money only sent to title or escrow company.

Now, I am good at telling people what not to do, so if anyone asks, I'll gladly crank out another seven not-to-do items, or if you would like for me to expand on any particular item on the list, I will give that a shot as well. Any comments or suggestions are always welcome.

The Basics of Trust Deed Investing

What is trust deed investing?

Trust deed investing is simply investing in loans secured by real estate. Most trust deed investments are relatively short term loans (maturity under five years, with many loans two years or less) made to professional real estate investors. In the current economic climate professional real estate investors are buying properties at foreclosure sales for bargain basement prices, fixing-up these properties, and reselling them for a profit.

Banks are reluctant to lend to this market not because the loans are particularly risky, but because banks have a great deal of bad real estate loans on their balance sheets as a consequence of the loose lending practices of recent years. Presently, banks are unwilling to make real estate loans unless they fit a very strict set of criteria. They often do not want to lend to opportunistic real estate investors because the property which is security for the loan is not "move-in ready" at the time of loan funding—it usually needs some work. For this reason, real estate investors have limited financing options available to them, and lenders to this market are able to command relatively high interest rates.

Who borrowers at these high interest rates?

The borrowers are real estate investors who are planning to make a very large return and/or strike a very favorable deal, and are willing to pay for a quick and simple source of capital.

These borrowers can often afford to pay lenders low double digit rates of return, even though the loan is well-secured, because the borrowers are typically aiming to make an annualized return of 35% -100% on their investment. Paying the lender a much lower return (relative to their projected returns) allows them to enhance the returns they earn on their cash investment.

Why are banks reluctant to lend to this market?

As of the end of the second quarter 2012, nearly 20% of the $2.6 trillion in mortgages on banks' balance sheets were delinquent. The secondary market for non-conforming mortgage backed securities is a fraction of what it used to be. For these reasons banks have tightened their lending standards and are reluctant to lend to anyone with less than picture perfect credit. It is precisely the banks' reluctance to participate in this market that has created the attractive investment opportunity in short term real estate loans. The fact that banks are not lending to this market has created a supply/demand imbalance that doesn't have anything to do with the quality of the borrowers, but instead with the condition of banks' balance sheets.

What makes trust deed investing attractive?

When structured properly, trust deed investments offer an attractive and above average yield secured by valuable real estate. Trust deed investors usually earn high single-digit annual returns, paid monthly. In some cases, returns above 10% are possible. These returns are very favorable relative to other investment options with similar risk profiles. The risk of losing money in a trust deed investment is mitigated by a built in "margin of safety."

What is the margin of safety in a trust deed investment?

The margin of safety is the difference between the loan amount, and the value of the underlying property. The core concept of trust deed investing is that if the borrower does not perform, the lender can foreclose on the property and sell it to recoup the investment, plus any past due interest. If the loan is sufficiently conservative, i.e. the property value is high relative to the loan amount, then the investment should not lose money even if the borrower defaults on

the loan. A well structured trust deed investment might have a loan-to-value of 65% or much less.

What are the disadvantages and risks associated with trust deed investing?

Trust deed investments are not liquid. In other words, you cannot decide you want your money back one day and quickly convert your investment into cash, as you could with a municipal bond or shares in a blue chip company. You need to be willing to stick with your investment until the borrower pays off the loan, or, in case of default, until you have foreclosed and sold the underlying property.

With Trust Deed investing there is little chance for capital appreciation. For the most part the only returns that the investor will be entitled to will come from interest income generated from the loan.

Directly investing in trust deeds requires that the investor identify borrowers, assess deals on their merit, and conduct due diligence on the borrower and the property. This all requires a particular knowledge set that the investor must be acquire.

Trust deed investing is not without risk. A small flaw in the documentation or due diligence of a trust deed investment could mean that an otherwise very safe investment becomes very risky. For example, litigation or title problems could cause problems if the borrower or some other party can make a credible claim that your trust deed instruments are not valid, or that they have some interest in the underlying property that is equally or more valid, the trust deed investor might need to battle to protect the investment.

Trust deed investing is not for the faint of heart. Amateurs need to take particular care, and seek guidance from trusted experienced investors. That being said, there are tens of millions of valid trust deeds owned by banks as well as hundreds of thousands owned by

private investors. Creating a valid trust deed and accompanying note is not rocket science.

What returns can trust deed investors expect?

As of 2012, investors can receive returns of 6-10% on trust deeds with a solid margin of safety (loan-to-value of, say 65% or less). The higher returns are possible for professional trust deed investors because they invest frequently and have close relations with mortgage brokers and mortgage banks that create trust deed opportunities.

Why do trust deeds yield more than bonds?

Individual trust deed investments are relatively small when compared to government or corporate bond issuance. For this reason it would be difficult for large institutional investors to put a lot of money to work into trust deeds. Therefore, the trust deed market is left to smaller investors who also have the expertise to distinguish good trust deed investments from bad ones, and because most trust deed companies are local or regional. The demand for borrowers seeking private money loans is much greater than the supply.

The combination of limited supply and high demand results in a high yield for trust deed investors. And because many investors place a high value on liquidity, being able to sell investments quickly and convert them into cash. Corporate and government bonds are some of the most liquid investments in the world. Trust deed investments on the other hand cannot be converted into cash quickly. This lack of liquidity contributes to the higher yield of trust deed investments.

Trust deed investing seems too good to be true. What is the catch?

The risk adjusted returns of trust deed investments are very attractive. But, there is no such thing as a free lunch. Because these investments are not liquid they cannot be converted into cash quickly. Secondly, there is real risk involved, the most obvious of which being that the borrower defaults and the lender cannot sell the home for more than the amount of the loan. To a great extent, risk can be mitigated by properly valuing the property and structuring the deal with a high enough margin of safety.
There is also the possibility of unanticipated legal disputes involving the property, the navigation of which could easily destroy investment returns. It is necessary to have advisors with relevant experience should a situation such as this arise.

Furthermore, while there are safeguards in place to protect against fraud, real estate transactions are susceptible to unscrupulous individuals looking to take advantage of unsophisticated lenders. Realizing the superior risk adjusted returns offered by trust deed investing is not for the faint of heart and requires a certain level of sophistication.

That being said, investing in trust deeds can be done in a safe manner. The investor needs to be armed with the proper knowledge and to take care in crafting each investment including conducting the proper financial analysis and thorough due diligence.

During the recent financial crisis, real estate loans suffered billions of dollars in losses. How are new investments in real estate loans any safer?

During the financial crisis, real estate values dropped about 40% from peak. Given that many real estate loans were set at 75% or more of market value, there was no way to avoid lenders taking

losses. In the latest financial crisis, lenders' losses were exacerbated by a number of factors including the following:

(1) Many residential loans were made at 80%, or even 90% of market value, so that the original margin of safety for the lenders was very slim;
(2) because of loose underwriting guidelines many loans were made to borrowers with poor credit;
(3) in the case of commercial real estate loans, some loans were for development of high rise buildings and subdivisions that only made sense under very optimistic assumptions.

Today's real estate loan investments are not immune from losses.

However, the risk is lower to the extent that:
(1) another 40% drop in values from today's much lower values is unlikely;
(2) experienced bridge lenders limit their loan amount to 60% or 65% of current market value;
(3) most bridge lenders require a personal guarantee and require that the borrower have good credit and a good balance sheet, and keep skin in the project.

Why don't major Wall Street firms offer trust deed investments?

In short, Wall Street firms cannot make enough money from trust deed investments to make it worth their while. The size of each investment and the work involved in creating each investment properly combine to make this business "non-scalable" from their perspective. It is the absence of huge amounts of capital in this market that explains the strong risk-adjusted returns available to those willing and able to participate in the market. However, Wall Street banks are major players in the securitized loan industry,

which does relate to trust deed investing and has been on hold to incomplete financial reform regulation.

How does the securitized loan market relate to and impact the market for trust deed investments?

Most real estate loans in our country are traditionally funded by a bank or other financial institution and held on the bank's balance sheet as an asset. Other loans are funded by the lender with the intention that the loan will be sold off within a period of weeks to an investor who will package the loan with others and then sell a security in the capital markets whose underlying assets include the loan.

Yet another variation for commercial real estate loans are Commercial Mortgage Backed Securities (CMBS). In this case, a Wall Street firm makes the loan using its own funds and then sells off the loan as part of a security when enough loans have been funded to create a diversified pool of loans.

What will happen if Wall Street increases its issuance of Commercial Mortgage Backed Securities (CMBS)?

During the financial crisis, the volume of CMBS loans plummeted from the record levels achieved before the crash. As the CMBS market recovers, it will absorb more loans that might have otherwise gone to private lenders. However, for opportunistic situations that require quick funding, and for un-stabilized properties that don't have steady cash flow, there is always a role for competent private lenders and trust deed investors.

How to Invest in Trust Deeds

How can I invest in trust deeds?

There are four options for an individual to invest in a trust deeds:
(1) personally source individual loans and lend money directly to real estate investors;
(2) purchase loans backed by real estate from brokers;
(3) invest in a fund that invests in trust deeds; and
(4) identify people who are directly investing in trust deeds as a group and invest along with them.

Is personally sourcing individual loans and lending money directly to real estate investors for me?

Unless you are a professional real estate investor with a significant amount of time available to manage your investments, the answer is probably "no". Personally sourcing deals, evaluating them, negotiating terms, and managing the legal issues is for very experienced real estate investors. While trust deed investments do have the potential to generate excellent risk adjusted returns, there is significant risk for investors who do not know what they are doing. Certain very experienced investors do put together deals on their own, but this requires legal expertise to review all the key documents, such as the loan documents, title issues and borrower underwriting. If outside counsel is hired, the legal fees associated with small trust deed investments can result in excessive transaction costs.

What can I do to gain the experience necessary to become an active trust deed investor?

The best way to take advantage of the opportunities available in trust deed investing right now is to invest with the help of a

trustworthy expert. One way to do this is through a fund structure, where a professional investment manager is responsible for sourcing and evaluating trust deeds. If your ultimate goal is to gain the knowledge necessary so that you can invest in trust deeds yourself, find somebody to personally show you the ropes. Find someone who is actively investing in real estate loans and would be willing to show you their process. Once you become comfortable with the basics, ask this person to mentor you as you apply the process and evaluate deals on your own.

Is it safe to invest on my own with the help of a broker?

Most trust deed investors rely on mortgage or real estate brokers to present them with opportunities and fully underwritten loan packages. Many investors also look to the broker to perform most of the due diligence on a given loan.

There is nothing wrong with sourcing investment through brokers, as long as the investor does not rely on the broker to perform the key due diligence tasks. Brokers are not a disinterested party. They work on a commission basis and are incentivized to broker as many loans as possible. This is not to say that there are not good brokers who are looking out for the interests of their clients, but ultimately their job is not to evaluate deals.

The onus is on the individual investor to evaluate the risks of a particular deal, which requires a specialized knowledge set. For experienced real estate investors, brokers can be excellent allies, a good source of information, and a great way to source trust deed investments.

What is the minimum investment for trust deed investments?

The minimum depends on who is offering a trust deed investment. Some investment firms allow investments as small as $20,000 while others require $100,000 or more. The minimum amount will similarly vary by broker. As a practical matter, the author of this FAQ believes it is better to invest a slightly larger amount, and to perform more thorough research on each investment, rather than spreading funds across a large number of very small investments where the research behind each investment was more superficial.

Why can very small trust deeds be more dangerous? How small is too small?

In some parts of the U.S. such as Detroit, homes in distressed neighborhoods now sell for as little as $20,000 or even less. If you make a loan of $10,000 secured by a property that is selling for $20,000, that is a 50% loan-to-cost, which should normally be fairly safe.

The problem is that while 50% LTC is good, in this case the margin of safety in dollars is only $10,000. If the loan goes into default, the cost to process a foreclosure might be $7,500 or more. Once the foreclosure is done, the lender's new cash investment in the property is now $17,500 rather than $10,000. The margin of safety is no longer enough to ensure a profitable exit.

Now suppose you discover work that needs to be done on the home that will cost $5,000. The total cost to foreclose and fix the property, plus the loan amount, equals $22,500, which is more than the value of the property.

In addition, when it comes to selling the home to recoup the investment, normal costs are 6% of the selling price which is split between buyer's broker and seller's broker. In this case, with a

$20,000 value, that would only be $1,000 ($500 each) and few good brokers would bother with all the work of selling a house for a $500 commission. For all of these reasons, very small loans hold unique risks. With a loan amount of $100,000 on a home worth $200,000, for the most part these issues go away.

Should I invest in an individual trust deed or in a trust deed fund?

Investing in individual trust deeds may yield a higher return than investing in a fund. This is the preferred approach for very active investors who have deep knowledge of real estate investing. Each loan requires a great deal of analysis and due diligence on both the borrower and the property. Furthermore, when a loan pays off the money sits in cash until it can be redeployed. Investing in individual trust deeds requires constant sourcing of deals so that when one loan pays off, the money can be reinvested quickly in another.

Investing in a professionally-managed fund is less time consuming and is often preferred by passive investors and those without deep real estate investment experience. A good fund manager will have the infrastructure and expertise to perform the requisite analysis and due diligence on the individual loans. An established fund manager will also be in a better position to source deals and ensure that money is continuously reinvested.

In either case, researching the “key person” who is creating the investment is very important—in the case of an individual investment, that is the broker arranging the loan. In the case of a fund, it is the fund manager.

What are the main risks of investing in a fund?

When investing in a fund, investors are delegating all day-to-day decisions to the fund manager. Evaluating the competence and

character (trustworthiness) of the fund manager is critical. If the fund manager is lacking at all in either area, the investment is a no-go. Investing in trust deeds can be done in a responsible low-risk manner, however, an incompetent fund manager can make mistakes that result in money being lost. In the worst case, a dishonest fund manager, such as Bernie Madoff, could steal the money that is supposed to be invested.

What is a fund's efficiency?

Efficiency is the percentage of a fund's assets that is invested, on average, during a period. Suppose that a $10 million fund has $8 million invested for six months and $9 million invested for the next six months, with the balance in cash. On average for the year, $8.5 million out of $10 million was working, with $1.5 million idle. The corresponding efficiency is 85%.

How does a fund's efficiency affect its results?

In the preceding example, suppose all investments earned 10% interest. The fund's returns would be 10% x 85% = 8.5% per year. Suppose another fund earns 12% on its investments but only keeps 70% of its assets invested on average. Its annual returns would be 12% x 70% = 8.4%. A fund manager's efficiency depends on the robust supply of investments that the manager can tap into. Efficiency affects performance and a highly efficient fund can outperform one that charges interest, while probably making lower-risk investments to boot.

Is it risky to participate in a loan with other investors?

There are some risks to purchasing a participation in a loan with other investors. Typically, the consent of a majority interest in the loan is required to make key decisions such as whether or not to begin the foreclosure process when a loan goes into default. Another challenge is that in some cases more cash may need to be invested into a property (for example, to fix it up so as to facilitate

a sale at full market value). Different investors have different appetites and resources to invest further funds, which could create challenges to doing what needs to be done.

Which is better, investing in trust deeds or investing in real estate?

It is not a question of which is better. Investing directly in real estate equity and investing in trust deeds are simply two different types of investments, each with advantages and disadvantages. With any investment there are two possible sources of return, income and capital appreciation. A direct investment in real estate can generate income and also appreciate in value. Trust deed investments only generate income.

That being said, there is a great deal of risk associated with a direct real estate investment. There is the possibility that properties generate negative income or lose value. Well-structured trust deed investments on the other hand, have a margin of safety not present in real estate ownership, due to a low loan-to-value ratio. In other words, the loan is secured by a property that is worth significantly more than the amount of the loan, which protects the lender in the event of a default. Additionally due to the recent credit crisis and banks' unwillingness to make these types of loans, the current yield on trust deed investments is significantly higher than what is available from a direct real estate investment.

Additional differences between the two types of investments are that income from real estate has favorable tax treatment, while trust deed interest income is treated as ordinary income. Also, real estate investors can use leverage to enhance their returns. And real estate investments lend themselves to a "buy-and-hold" approach. Trust deed investments have a natural maturity, at which time the investor must find a new investment in order to continue earning a return.

Which are better as an investment, residential or commercial trust deeds?

Neither is better, but they are different. Commercial properties such as multi-unit apartment buildings or shopping centers are valued based on the cash flow they produce each year. Single family residential properties are value based upon comparable property sales in the neighborhood, not on their income potential.

Commercial property trust deeds require extra due diligence that is not familiar to the average investor. For example, when investing in a trust deed secured by a shopping center or an industrial building, it is critical to have an environmental assessment of the property prior to funding. The presence of any environmental problems is a major red flag and could expose the trust deed investor to significant liability.

In either case (commercial or residential trust deeds), the key is to make sure that the loan-to-value (LTV) is conservative—60% or less is a good rule of thumb. See the paragraph on the meaning of LTV elsewhere in this FAQ. Having an LTV that is far below 100% ensures a margin of safety for the trust deed investor.

Can I use an IRA for trust deed investing?

Yes. The first step is to work with a self-directed IRA custodian company. These firms specialize in administering IRAs that are invested in alternative asset classes such as real estate, trust deeds and commodities. Two established firms based in California that provide these services are Pensco Trust (www.penscotrust.com) and Entrust(www.theentrustgroup.com). Costs for administration are in the range of 0.3% to 0.5% of assets under management, per year.

Why would I want to use IRA funds instead of other funds to invest in trust deeds?

Income received into an IRA or other qualified retirement account can be re-invested tax-free. The taxes are due when the funds are withdrawn from the account. Income from trust deed investments is treated as ordinary income. In other words, it is taxed at a relatively higher rate than some other types of income. Investing in trust deeds from an IRA account neutralizes this disadvantage of trust deed investments vs. some other types of investment that are taxed at a lower rate.

What Can Go Wrong

What can go wrong investing in real estate loans?

Trust deed investing results in one of two outcomes: (1) the borrower performs, or makes all interest and principal payments stipulated in the loan agreement; or (2) the borrower defaults. In the case of a default, the lender has a clear pathway, called foreclosure, to taking over the property that is the security for the loan. Once the foreclosure is done, the investor can sell the property to recover the investment. I had an illustrator create the cartoon below to show the two possible paths.
As with any investment, there are risks and in case of a default by the borrower, there are several things that could create challenges.

Some examples include the following:

- a sharp drop in real estate values;
- a mistake in estimating the property's true value;
- bankruptcy by the borrower;
- litigation affecting title to the property; and
- mortgage fraud or other defects on title.

These five situations are discussed in their own respective FAQs.

What happens if real estate values drop sharply during the course of a trust deed investment?

The equity risk of the real estate investment is borne by the borrower. If real estate values drop, the borrower takes the first loss on their investment, and is still obligated to make interest payments and ultimately pay off the loan. In the event that the borrower defaults on the loan (stops making interest payments or fails to pay off the loan at maturity), then the lender generally has two choices. The lender may either (1) foreclose and sell the property, hoping that the proceeds are still high enough to pay off the loan even in light of the drop in values; or (2) encourage the owner to sell the property without pursuing a foreclosure.

If the proceeds from such a sale are not enough to satisfy the loan in full, then the transaction is referred to as a "short sale." It is "short" in that the lender is agreeing to the sale even though the lender will come up "short" of the amount of money they should receive under the loan terms. In either case if the property is sold for less than the value of the loan and interest owed, the trust deed investor (lender) would take a loss on the investment.

The lender can protect himself against a sharp fall in property values and a subsequent default by ensuring that the loan-to-value (LTV) is conservative—60% or less is a good rule of thumb. The higher the value of the property relative to the loan amount the greater the margin of safety. The lower the LTV, the more the property value would need to fall before the lender would take a loss.

What happens to trust deed investments when interest rates rise?

Trust deed investments are generally short-term loans of 12-36 months. Because they have a short maturity, the value of a trust deed investment will not change much even if interest rates rise.

In contrast, fixed income investments with a longer maturity, such as municipal or corporate bonds, drop in value when interest rates rise.

For example, a bond with 15 years left until maturity might fall as much as 15% in value if the interest rate rose by just 1%. For those who are interested in the math, see http://en.wikipedia.org/wiki/Bond_duration.

What happens if the value of the underlying property is estimated incorrectly?

Suppose you make a $200,000 loan investment on a property whose value you estimate to be $300,000. The margin of safety is $100,000. In case of default and foreclosure, the $100,000 should be enough to pay a brokerage fee (5% of $300,000, or $15,000) plus any legal fees incurred during the foreclosure (perhaps $5,000 or so).

Now suppose that the real property value at the time of the loan was only $250,000. The margin of safety was only half what it was intended to be. In this case, there is still enough equity in the property to exit without taking a loss.
Now combine a mistake in estimating the property value with a drop in real estate values, or deterioration in the condition of the property (such as a leaky roof that results in extensive water damage, or theft of appliances). At this point the trust deed investors may not be able to recover their entire investment.

What happens if the borrower files for bankruptcy?

In short, this will cause a delay in being able to foreclose on the property. In California, the foreclosure process takes about four months from the time of filing the notice of default to the time of the foreclosure sale. If the borrower files for bankruptcy, that could

add weeks or months to the timeline. In general, if there is equity in the property, the bankruptcy process will take longer. Also, a bankruptcy judge has the ability to re-write key terms of the loan. For example, the judge could reduce the interest rate on the loan.

What are some examples of title issues or litigation that could cause problems?

There are any number of legal issues that might arise clouding title to a property, compromising the lender's claim to the collateral securing the loan.
An example of what could happen is that the lender finds out, after it's too late, that a property line cuts through the building securing the loan.

Another issue could be that an adjacent property owner sues, and places a lis pendens on the title, claiming that the subject property violates building codes and subsequently diminishes the value of their property.

The property securing your loan may have previously been involved in a case of mortgage fraud, resulting in a lis pendens being placed on the property until the case is resolved.
It is also possible that the borrower, unbeknownst to you, takes out two loans on the same day using the property as collateral, one of the lenders will invariably end up in a junior position.

These are just a few examples of what could happen. Property titles are susceptible to legal disputes. And as a trust deed investor it is important to conduct due diligence on the property in order to avoid becoming involved with a property with the potential for becoming the center of a dispute. Of course in the event that legal issues do arise, it is important to be able to navigate these issues as expediently a possible less legal fees destroy investment returns.

What is a lis pendens? How does litigation surrounding a property affect a trust deed investor?

The term "lis pendens" means "legal action is pending". For example, suppose someone sues the owner of a property, alleging that the owner owes money and the property was pledged as collateral for a loan. The plaintiff's lawyer may file a lis pendens on the property in question, to prevent the owner from selling the property and hiding the proceeds. A lis pendens is a very serious action because it clouds title to the property in question and could take many months to resolve. In other words, other parties will stay away from entering into any transactions involving a property so long as the lis pendens remains. Therefore, recording a spurious lis pendens exposes the party recording the lis pendens to liability.

For a trust deed investor, a lis pendens is one of the more dangerous developments that can take place. If the legal case has merit, then the lender may have trouble exiting the transaction in a timely way, even assuming the lender has done nothing wrong.

What is mortgage fraud?

Mortgage fraud occurs when a borrower has stolen money from a lender without giving the lender the security promised, or has otherwise conspired to defraud the lender.

In one type of mortgage fraud, the borrower obtains a false appraisal and borrows more money than the property is worth, with no intention of paying the money back. Another scheme involves bringing in an unsuspecting party to become the owner of the property and using his or her good credit to borrow money.

The best way to ensure no mortgage fraud enters into a trust deed investment is to assess the credibility of all the parties involved in a transaction, and to make sure that all of the pieces of the transaction make sense for each party involved.

What if a fire destroys the building that is security for a trust deed investment?

The lender should be named as an "additionally insured party" on the fire insurance at the time of the investment. This way, in case of a fire, the lender should receive their original investment back even if the borrower defaults.

What if an earthquake destroys the building that is security for the trust deed?

Southern California is very active seismically and there is a possibility that an earthquake severely damages or even destroys a building. If the borrower carries earthquake insurance the lender should be named as an "additionally insured party". In the event that the building is not insured and is destroyed in an earthquake, and the borrower defaults, the trust deed investment will lose a significant portion of its value since the property value would be reduced to land value, minus the cost to demolish and haul away the remains of the building. It should be noted that even in a strong earthquake, total destruction of the building beyond repair is quite unlikely.

Investing in a portfolio of trust deeds on various properties, or in diversified fund that holds a portfolio of loans, should mitigate the risk of loss due to a severe earthquake.

Details of a Trust Deed Investment

How much time does it take to invest in trust deeds?

To be an active trust deed investor, the largest time investment is the up-front investment required to learn how to distinguish between solid investments and risky ones. Once those skills are learned, trust deed investment is not necessarily very time consuming. It takes much more time than buying a bond or mutual

fund, but it need not be a full-time job. The tasks involved include sourcing prospective deals, evaluating the deals on their economic merits, and conducting due diligence on the property and borrower. Most trust deed investors integrate these tasks with other related work such as managing real estate that they own. Experienced trust deed investors might spend ten hours over the course of a week to identify and consummate an individual investment.

Participants in the Trust Deed Market

What is a hard money lender?

A hard money lender is a non-bank lender that makes loans that fall "outside the box" of bank lending standards. To compensate themselves for moving quickly and funding loans banks won't fund, hard money lenders charge higher rates than banks. They also charge a fee to the borrower at the time a loan funds. This is called an origination fee and is expressed in points. Each point corresponds to 1% of the loan amount.

Hard money lenders are frequently successful real estate investors who have extra cash. They prefer to lend money rather than leave the cash in a bank account or money market fund earning 1% interest or less.

There are two main types of borrowers who are willing to pay the double digit interest rates charged by hard money lenders: (i) savvy investors who are planning to make a very large return and/or strike a very favorable deal, and are willing to pay for a quick and simple source of capital; and (ii) homeowners with poor credit who don't qualify for any other type of loan.

Trust deed investors should only invest in loans to the first type of borrower.

Is there a difference between bridge lenders and hard money lenders?

The terms bridge lender and hard money lender are sometimes used interchangeably. Both types of lenders focus on making short-term real estate loans. Sometimes the term hard money loan signifies a loan where the borrower's credit is not good, whereas bridge loans are frequently loans where the borrower's credit is good but the property is not in a condition to qualify for a traditional bank loan. Hard money loans are always expensive whereas bridge loans can sometimes carry interest rates close to those on traditional/permanent bank loans.

What is the role of the mortgage broker in a trust deed investment?

Most trust deed investors work through a broker who brings together the borrower and the trust deed investor. In some cases, the broker allows multiple investors to purchase participations in a single trust deed. This is particularly common on larger, commercial real estate trust deeds.

In many cases, the investors rely on the broker to a large extent to perform the key tasks that ensure the trust deed is a safe investment. For example, the broker frequently runs the credit on the borrower; opines on the value of the real estate that is security for the loan; and signs off on the acceptability of the title report and loan documents.

When investors rely on the broker to perform these key tasks, they need to understand that an error by the broker could easily result in a loss of some or all of their investment. In other words, the investor should retain their own real estate legal counsel on each investment (for title and loan document issues), and/or choose very carefully which broker or brokers to work with.

What is the role of the loan servicer?

The loan servicer collects interest payments from the borrower and disburses them to the lender. The servicer also initiates the foreclosure process at the request of the lender in case of default by the borrower. One of the largest servicers for trust deed investments in California is called FCI Lender Services. For more information, see www.trustfci.com.

How can I check out a provider of trust deeds?

When choosing an advisor or broker in the trust deed arena, make use of a wide variety of techniques to check out the person's reputation. The best technique is to find someone you know and trust who has worked directly with the broker. Web-based professional networks such as LinkedIn can be useful in finding mutual connections. Ask your friends and professional contacts for references to reputable people involved in the trust deed market. Lawyers and CPAs who deal with real estate matters can often recommend someone. Ask for references from people whom you know and trust, and whom you believe to have good judgment in the area of investing. These people will tend to recommend capable professionals who know what they are doing.

How do I know if a particular TD is safe?

There are four broad areas of due diligence required for a trust deed investment: (i) property/value assessment; (ii) borrower; (iii) legal items; and (iv) other items, including the broker/intermediary, if applicable. A trust deed is safe if all four areas check out properly. Each area will be addressed in a separate FAQ.

What is a junior loan? Why are junior loans riskier than senior loans?

A junior loan is any loan other than the first trust deed. Junior loans are riskier than senior loans because they have lower priority in case of a default by the borrower. If the senior loan on a property goes into default, the junior lender stands to lose his or her entire investment. To protect the junior lien, the investor in the junior loan must "cure" the default in the first, which means making the payments on the senior loan. For this reason, junior loans need to generate a much higher return in order to be worth the extra risk. See also the next FAQ for more details on this subject.

In the term "first trust deed", what does the word "first" mean?

A first trust deed is a first lien on the subject property, meaning that there are no other loans that have a superior position in case of a default and foreclosure sale. In contrast, a second trust deed is second in line in case of a default. If the first trust deed holder forecloses on the property, the second trust deed holder's investment is wiped out. On the other hand, if a second trust deed holder forecloses on a property, the first trust deed is NOT wiped out. The second trust deed holder becomes the new owner of the property, subject to the existing first trust deed, which remains in place.

Underwriting Investments

Do I need to see the property before investing in a trust deed?

Yes, if you are investing directly into a trust deed, you should see the property first. By inspecting the property and recent comparable sales nearby, you can determine for yourself whether you think the value of the property is as represented or not. Also, suppose that a fire destroyed the property the day before you

planned to invest. The only way to know for sure that you are in a good position is to see the property itself.
In the case of a passive investment in a fund that holds trust deed investments, the responsibility to inspect each property falls on the fund manager.

What should I look for when I inspect a property prior to investing in a trust deed secured by that property?

First, do not skip the important step of inspecting the property prior to funding a trust deed investment. By seeing the property, you will learn things that you could not find out any other way. Especially if the loan goes into default for some reason later, you will be much calmer being able to visualize the property and the neighborhood, and this will allow you to make better decisions. Seeing the property after a default is important too, but it is no substitute.

When inspecting the property, you should focus on two questions: (1) how much is the property worth?; and (2) how easily could I sell the property if I took it back through foreclosure and I needed to get rid of it? As to the value, you will look for the same kinds of things a home buyer would look for. Is the neighborhood appealing? How does the home show? Are the flaws things that could be fixed easily, such as needing new paint and carpets, or major issues, such as structural issues? Be cautious about hillside properties and look for any signs of structural problems, which could be very expensive to fix.

As to marketability, beware of neighborhoods with excessive numbers of homes in foreclosure. These homes will make it hard to sell any other home in the neighborhood, without dropping the price to a “fire sale” price. Look for pride of ownership in neighboring properties. Even inexpensive homes can be kept up

with care, and this is a good sign that the neighborhood is sound and that buyers will want to live there.

How do I perform a value assessment of the property?

Let's assume the property is a single family home. The key technique is to look at recent sales of similar properties nearby. Sales more than six months old are not reliable, because the market might have changed. Look at the absolute price at which the properties sold, as well as the price per square foot. Assuming you can find homes of similar size and quality that sold nearby recently, the amount of your loan should be much lower than the typical selling price of the other homes—both in absolute dollars in dollars per square foot of living space.

For example, if I am lending $200,000 on a 2,000 sq. ft. house, which equates to $100 per sq ft, then I want similar homes to be selling for $300,000 or more, or $150 per sq ft or more. This ensures that I have a large margin of safety in case of a drop in the market during the loan term.

What is LTC? Why is it important?

LTC means loan-to-cost. If a property is being purchased for $300,000 and the trust deed investor is providing a new loan for $200,000 on that property, then the LTC is 66.7%. LTC is important because it shows how much "skin in the game" the borrower has. Even if a borrower is making a terrific buy, we will not lend 100% of their cost, because in that case the borrower would have no cash investment and nothing concrete to lose in case things did not go as planned.

What is LTV? Why is it important?

LTV means loan-to-value. If a property is worth $400,000 and the loan amount is $240,000, then the LTV is the ratio of these two numbers (60%). The LTV is important because the margin of safety is directly related to the LTV. A low LTV means a higher margin of safety for the lender. An LTV of 60% or lower is generally a good signal, although for a very small loan even a low LTV may not equate to a safe loan (see FAQ on very small loans, below).

What is the difference between LTV and LTC?

Homes purchased at foreclosure sales are often purchased for less than their fair market value. Loan-to-cost (LTC) is a measure of how much equity a borrower has in a property and therefore is an indication of their financial motivation to repay a loan. Loan-to-value, on the other hand, is a more relevant measure of a lender's margin of safety. Both ratios are important considerations when structuring a trust deed investment. As an increasing number of investors bid on homes at foreclosure sales prices are being pushed up closer to fair market value, narrowing the gap between LTV and LTC.

How do I assess the quality of the borrower?

First, remember not to lend on owner-occupied homes in California. State law is very owner-oriented resulting in potentially extreme delays and obstacles to being able to foreclose in case of a default.

Assuming you are lending to an investor on a non-owner occupied property, you need to evaluate both the creditworthiness and the character of the borrower. To evaluate creditworthiness, review a credit report and also make sure you look at the borrower's personal financial statement and tax returns. Focus on the liquidity

of the borrower. If something unexpected goes wrong, will the borrower have the cash available to solve the problem and get the project done?

Regarding the borrower's character, this is a complex topic hard to address in an FAQ. Suffice to say that, if you intend to make direct trust deed investments, you need good judgment and a good nose for sniffing out anything that doesn't seem right. If you don't have this skill, you are probably better off investing passively in a fund managed by a reputable, expert investor.

How important is the borrower's credit? How does one read a credit report?

The quality of the borrower's credit—in other words, the likelihood of a default by the borrower, all other things being equal—is very important in any trust deed investment.
We all know some people who take their commitments very seriously and other people who are more nonchalant. The credit report, and the FICO scores in such a report, are one tool for determining a borrower's credit.
For more information about credit scores.

Just as important as a credit report is a personal financial statement. The next FAQ addresses this tool.

What is a personal financial statement?

A personal financial statement is a snapshot of an individual's assets (such as cash, securities, real estate and automobiles), liabilities (including mortgages on any real estate owned) and net worth (defined as the difference between assets and liabilities). Lenders require borrowers to submit a personal financial statement before deciding whether to make a loan. The personal financial statement tells a lot of information about the borrower. Does this person drive fancy new cars even though the person has a small net

worth? Does the person have the maximum amount of leverage possible on every asset? A good borrower is one who is not pushing the envelope in every way. Ample liquid assets are always a good sign from the lender's perspective.

What are points?

The term points refers to the origination fee charged by a private or hard money lender at the time a loan is funded. Each point corresponds to 1% of the loan amount. A fee of three points on a $400,000 loan would be $12,000. Hard money lenders typically charge between one point and three points for high quality loans. For riskier loans, a larger origination fee is common, up to five points or even higher.

What is a prepayment penalty and why do they exist?

A prepayment penalty is a fee that borrowers pay if they pay off a loan before it is due. Hard money lenders frequently charge a prepayment penalty as a way of enhancing their returns. A pre-payment penalty may be as little as one month's interest or a multiple of that amount. The justification for a prepayment penalty is that the lender will now need to expend time and energy to re-deploy the money from the loan that paid off, before the loan was scheduled to pay off.

What happens when a loan pays off?

When a loan pays off, it is a good thing in that the investment was successful. On the other hand, the investor now has cash in the bank that is earning 1% or less. Most trust deed investors look for another trust deed to invest in when one pays off.

In actively managed trust deed investment funds, it is the job of the fund manager to keep the money working. If too much money is in cash at any given time, this will create a drag on the returns of the fund. Investors who prefer to invest in individual trust deeds may

get higher returns while they are invested, as compared to investors in trust deed funds. However, when the “downtime” of such investors is taken into account, the returns may not be very different.

What about out of state TDs?

As stated previously, it is very important to see the property personally before investing in trust deeds, or to delegate this task to someone whose competence the investor trusts completely. As a rule of thumb, only invest out-of-state if the loan and origination fee are large enough to justify the time and expense of a site inspection or trusted appraiser. Remember that real estate laws differ in every state, so it is critical to work with loan originator familiar with the states laws on each investment.

In the Event of a Default

What happens if the borrower doesn’t perform?

A default occurs when the borrower fails to make an interest or principal payment, or fails to live up to some other provision of the loan agreement. At this point, the lender instructs the loan servicer (an independent company that deals with the borrower) to file a notice of default. This is the first step in a series of events that culminates in a foreclosure sale. In California, it takes about four months to hold a foreclosure sale after the notice of default is filed. At any time prior to the foreclosure sale, the lender and borrower could make arrangements that would obviate the need for the foreclosure sale.

For example, the borrower could cure the default by bringing all of his or her payments current. Or, the lender could give the borrower an extension on the loan maturity.

When a foreclosure sale takes place, there are two main outcomes. Either the lender ends up owning the property; or, someone else makes an all-cash bid to purchase the property and the lender accepts that bid instead of taking back the property.

What is the foreclosure process like and how difficult is it to manage?

The foreclosure process varies from state to state. In California it takes about four months from the initial default by the borrower until the foreclosure sale. The key to handling a foreclosure smoothly is to have an experienced trustee and real estate lawyer. The trustee's job is to provide proper notices at each stage of the foreclosure process to ensure that the process is deemed valid. The real estate attorney helps negotiate any special circumstances such as a bankruptcy by the borrower.

Trust deed investors need to be prepared for a default on any given loan. The foreclosure process takes time and money but the key processes are outsourced and can be managed by the investor fairly easily.

How long does it take to exit a trust deed investment in which the borrower defaults?

The amount of time varies by state. In California, it takes about four months to foreclose, if the lender takes action immediately at the time of the default. The property is then fixed up, if necessary, and listed for sale. The selling process itself should take 45-60 days if the property is priced properly. Therefore, the entire process of exiting a defaulted trust deed investment is about six months. In other states the timeline and process vary and can be longer. A bankruptcy by the borrower adds time to the process, possibly 30-90 days.

On the other hand, expert handling of the default could shorten the

exit time substantially. For example, if the lender and the borrower work together, instead of a foreclosure, the home can be sold without a foreclosure, cutting the process down to about 60 days instead of six months.

Someone I know has been trying to sell her house for over a year with no success. How can a trust deed investor sell a foreclosed house in a few days?

There is a price at which every property will sell. The reason that someone might be having difficulty selling a house is that the asking price is too high. A trust deed investor who has foreclosed on a house is interested in selling the property quickly and will price the house to sell.

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