The Interest Rate Shouldn't Be the End of the Discussion

Sophisticated borrowers will value originators who provide a nuanced picture of loans

By Robert Greenberg

While the interest rate is certainly important for real estate investors and homebuyers alike, the wide variety of loan products available in today's market makes it critically important for mortgage originators serving real estate investors to understand the nuances among these products and the benefits to their clients.

These nuances could create a situation where a higher interest rate loan can ultimately cost a client less over the life of the loan depending on how the loan is structured. As conventional mortgage lending for residential owner-occupants became more homogeneous in the wake of the financial crisis, business-purpose loans for residential investment properties became more innovative and more widely available from a variety of lenders offering different products to meet the unique needs of real estate investors.

Innovative lending

As traditional banks and nonbank mortgage lenders were tightening up credit and dealing with a flood of owner-occupant delinquencies, defaults and foreclosures, the real estate investment space began to see exciting changes and innovation in mortgage products and lending platforms.

As housing prices declined during the housing crisis, real estate investor interest in buying significantly discounted properties began to skyrocket. Online lending platforms using sophisticated algorithms to underwrite loans based on asset value and cash flow rather than a borrower's personal income came to the forefront in a meaningful way to meet the demand for real estate investment financing.

Many of the online platforms serving the needs of real estate investors didn't exist prior to the housing crisis. Before they emerged, residential real estate investors, especially in the fix-and-flip market, typically turned to local hard-money lenders for their financing needs.

Communicating cost

With these additional financing options, mortgage originators should be well-versed in the nuances of different loan programs to steer their clients into loan products that make the most sense. Frequently, in an investment scenario, that is the loan program that offers the lowest cost of capital to the borrower.

For instance, in the fix-and-flip lending space, sometimes a purchase and rehab loan at a higher interest rate can actually result in a lower-cost option for the borrower. The challenge for those serving this market is two-fold: how to structure a loan with an interest rate that can ultimately save borrowers money, and how to communicate the true cost of the loan to prospective borrowers.

An important component of many fix-and-flip loans is the ability to finance construction costs, which typically get disbursed over the life of the loan through construction draws. Instead of rolling those costs into the initial loan payment, lenders will sometimes charge interest only on funds that have been dispersed.

When examining mortgage products for clients in the fix-and-flip space, there are two key questions that should be asked:

- **Will the borrower** pay interest on the money required for the rehab as funds are dispersed over time or will the investor pay interest on the full amount of the loan, including the complete construction budget, regardless of the disbursement schedule?
- **What will the disbursement** timing and frequency be?

This is most apparent when looking at the total interest expense for loans that charge interest only on funds disbursed versus a loan in which the lender charges the same interest rate on the full loan amount established when the loan closes.

Analyzing details

Let's look at an example considering a $600,000 loan with a 10 percent interest rate — assuming a $500,000 purchase price and an additional $100,000 rehab budget to be paid out in five equal disbursements over 10 months.

In the first month, the borrower pays $4,166.67 in interest. That goes up to $4,333.33 after the first draw in the second month, then $4,500.00 for the second draw and so on. A borrower who takes the full amount upfront would pay $5,000 interest each month.

Under this scenario, the first borrower would actually pay $55,833.33 of interest at the end of the first year compared with $60,000 for the second borrower. That's a savings of more than $4,100 for the first borrower, with a lender charging interest only on funds disbursed. In that scenario, the actual interest paid would net out to a 9.3 percent interest rate compared to the quoted 10 percent.

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It's important for originators to clearly explain exactly how borrowers will be impacted by the interest rate based on the loan structure. Such nuances can add significant cost for investors — especially those financing large portfolios that contain anywhere from a handful to hundreds of residential properties.

While real estate investors are often sophisticated borrowers who are comfortable leveraging cash to grow their portfolios more quickly, the loan terms can be complicated and the actual costs not readily apparent without analyzing the details.

Comparing scenarios

It would be advantageous for mortgage originators to take two potential loan agreements with different scenarios on how the interest rate is charged and place them side by side. Then, do the necessary calculations to determine which financing approach works best for a particular situation.

Investors will value a mortgage professional who is taking the time to provide a comparison of interest payments associated with differing construction-draw schedules, for example. Providing these calculations can help borrowers better determine which schedule makes the most sense for their particular situation.

As is evident in the example provided, the best deal could be the loan product that has a higher interest rate — the one that on its face an investor or borrower might label as the more expensive option. Yet, in some scenarios, that higher-rate loan product may actually be the one that can save the client several thousand dollars.

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Satisfied customers who feel their mortgage originator truly understands the nuances of the innovative loan products now available are more likely to become return customers. That's especially the case when they are able to save money on financing that can ultimately be put to work expanding their real estate portfolios. ■