ARTWORK BY KAREN STEICHEN

By Erica LaCentra
Director of marketing, RCN Capital

Escape the Wild West

Private lenders are adopting set underwriting standards to protect borrowers

Commercial mortgage brokers tend not to associate hard money, or private money, with a strict set of underwriting guidelines. Long regarded as the wild west of the lending world, the hard money realm historically followed a model of letting each lender establish a standard as they go. Hard money came to be known for its flexible underwriting — the fewer guidelines, the better. ★ The single-family rental (SFR) business has changed this model, however. Institutional lenders with a nationwide reach have entered the space. And private lenders now find themselves underwriting to the guidelines of their financing partners, rather than following their own common-sense underwriting.

“Instead of making the standard up as they go, the lender can offer loan programs with more consistent guidelines.”

<< **Escape** continued from Page 31

Commercial mortgage brokers who work with borrowers in the SFR space should know that private money lenders are now likely to have a thorough underwriting process. Brokers and investors may view this as an inconvenience that makes obtaining financing more difficult. Quite the opposite is true, however.

Establishing set underwriting makes it easier for private lenders to scale their business. Instead of making the standard up as they go, the lender can offer loan programs with more consistent guidelines as well as a predictable origination process. Brokers and investors can determine which scenarios will and won’t qualify for financing, and they also can learn to expect a certain interest rate and leverage amount for all future scenarios. These factors aren’t at the whim of the lender.

The first look

Mortgage brokers should be aware of what private lenders typically examine in each borrower’s file. Initially, the underwriter will review a few essential items — the loan amount, the loan-to-value (LTV) ratio and the minimum FICO score — to ensure the borrower qualifies under a program’s guidelines. From there, the file will be vetted for errors that would trigger an automatic denial. This so-called “pre-underwrite” is meant to ferret out issues at the beginning of the process and save time.

In this preliminary stage, the underwriter often will review the borrower’s prior investment experience, as it affects the loan’s structure. The underwriter also will look for mathematical errors and the borrower’s expected return on investment. At this point, it is the underwriter’s job to flag any major concerns that would constitute a denial so as to not draw out the process. If there are no major issues, the underwriter would then continue with a full file review.

An underwriter typically begins with this review of the documentation and the borrower’s eligibility, but the main job of an underwriter is to find indications of fraud. In the private lending industry, fraud shows up in many forms. An underwriter’s job is to spot the red flags within a file. This work ultimately protects both the lender and the borrower.

Looking for red flags

In the SFR market, one major type of fraud involves the occupancy status. The borrower may move into an investment property after initially stating they do not intent to do so. Owner-occupancy fraud can cause numerous legal issues for a commercial mortgage lender. Thankfully, there are often telltale signs of occupancy fraud.

In a refinance scenario, an underwriter can simply check a borrower’s identification, background report and credit report to see if the address of the subject property matches that of their primary residence. For a purchase loan, however, it is a bit trickier. An underwriter will check to see if the borrower has ever purchased a home as a primary residence or for investment purposes. If the borrower has never bought a property in any capacity, this can be a red flag that the borrower intends to occupy the property as a primary residence.

An individual, for example, may live with their parents or other family members, and apply for a loan for investment

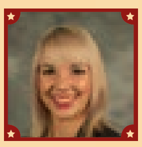
Continued on Page 34 >>

KEY POINTS

Common scams in rental-property transactions

- ★ Altering W-2 forms, bank statements and income-related documents to paint a strong financial picture of the borrower
- ★ Inflating appraisals or producing overly optimistic projections for vacancy rates, rent prices or property expenses
- ★ Equity skimming, or taking out a loan to collect the rental income and recoup the initial down-payment, but then making no mortgage payments and allowing the property to go into foreclosure
- ★ Short sales in which a straw buyer purchases a property and defaults, allowing a new investor to purchase the property for an amount that may be well below market value

Source: Smith & Howard



Erica LaCentra is the director of marketing for RCN Capital and is responsible for planning, developing and implementing the company’s marketing plan as well as overseeing its marketing department. Since joining RCN Capital in 2013, LaCentra’s ongoing efforts have rapidly expanded RCN’s customer base and elevated the company to a national brand. She currently serves as a member of the American Association of Private Lenders’ (AAPL) education advisory committee. Reach LaCentra at (860) 432-5858 ext. 1267 or elacentra@rcncapital.com.

<< Escape continued from Page 32

purposes. Although it is conceivable that the borrower does intend for the property to be an investment, it also is a warning that the individual potentially plans to occupy the home. The underwriter will typically request that the borrower confirm in writing that the purchase is for investment-related purposes. This will provide an added layer of legal protection for the lender should the borrower occupy the investment home.

Stamping out fraud

An underwriter also runs into other types of fraud. Another scenario is when an investor uses another person, commonly known as a "straw borrower" or "straw buyer," with better credit to either qualify for a loan or to obtain a loan with better terms.

> "Mortgage brokers and investors should expect added due diligence when financing SFR properties with private money."

Take, for example, a young college student who is applying for a loan for an investment property. If this borrower recently made a large deposit in their bank account, it could be a red flag that the borrower is being used by another individual to get a loan for a property purchase. The second individual may have poor credit and can't qualify for a loan, so they are getting this person to act as the straw borrower. An underwriter would immediately ask for an explanation of where the money in the bank account came from to ensure the legitimacy of the transaction.

Straw buyers also can be used to inflate the sales price of a property. A well-connected and savvy investor may, for example, flip a home repeatedly with other investors in their network to quickly increase the value of the subject property. Underwriters will spend additional time reviewing purchase and sale contracts when they suspect that a property's value has been manipulated. In this scenario, the underwriter will request copies of the underlying contracts, then follow the entire money chain to determine who has paid the owner of record in these previous sales.

Mortgage brokers and investors should expect added due diligence when financing SFR properties with private money. This shouldn't be viewed as roadblock, however. The underwriter is not only protecting the lender from fraud — they also are protecting the borrower.

Fix-and-flip and buy-and-hold rental-home investments have gained popularity, but inexperienced borrowers are at a higher risk of being taken advantage of in these deals. Underwriters often foil fake turnkey investment opportunities that are too good to be true, and stop transactions in which a borrower appears to be under duress. Underwriters have a responsibility to protect their lender's clients.

■ ■ ■

As set underwriting guidelines become more commonplace in the private lending industry, it's important to remember that they exist for the benefit of the investor as well as the lender. Lenders have greater peace of mind that every loan is secure. Investors can still get the fast financing they've come to expect from private lenders, but with a more consistent process and added behind-the-scenes protection. ■