Diving into Loan Pools

Private money offers hope for borrowers and opportunity for brokers

By **Timi Pereira,** CEO and president, Goldenomega.net

TRADITIONALLY, FUNDING private-money loans and investing in mortgages or trust deeds were financial dealings reserved for a select group of people who understood the intricacies of these transactions. Then, private-money funds — also known as hard money — were based primarily on equity. The interest rates on these loans, which were used for refinances and purchases, were more than what banks charged because borrowers were considered high-risk.

Sometimes, hard-money borrowers were unemployed or had incurred a recent foreclosure. Because of the risk, private investors could see annual returns of 10 percent to 15 percent. Moreover, the loans often were secured by real estate with loan-to-value ratios of 80 percent or less. Mortgage brokers who originated these loans often would charge higher points upfront, servicers would collect fees from investors, and borrowers could receive loan proceeds in as few as three days.

Private money continues to be a major player in today's mortgage and finance industries. In many cases, today's private money is used to acquire loans from failing financial institutions. Many of the private-money firms that participate in this type of investing operate as a mortgage pool or mortgage fund in which investors purchase shares.

Mortgage brokers looking to augment their industry participation can start these firms — typically established as limited liability companies — and position themselves as fund-managers. Investors who buy into such a fund become members of the company, while the manager makes day-to-day investment decisions.

Establishing a mortgage fund requires significant research and work. It can, however, lead brokers to increased income and better enable them to help borrowers maintain property-ownership.

Licensing and shares

Different states may require different licenses for the operation of mortgage funds. Brokers must understand the rules for the states in which they plan to work and file the required paperwork. Hiring a competent lawyer with securities experience is typically the first step. The lawyer also should be able to draft and file a private offering with the U.S. Securities and Exchange Commission.

Investors typically make their returns from the interest paid on purchased loans or investments in new loans minus the managing firm's charges and expenses. Investor payouts can vary depending on the type of shares offered. Guaranteed-rate and nonguaranteed-rate shares can be available. Distributions can take the form of cash or can be reinvested in the mortgage pool on a cash or accrual accounting basis. They can be made monthly, quarterly or annually.

The fundamental idea behind many new mortgage funds is to purchase troubled loans at a discount and to establish new payment terms for borrowers when necessary. Usually, the fund-manger decides which loans or groups of loans to buy, what types of modifications to allow and which new loans to invest in. Wise fund-managers carefully study a loan pool before purchase and treat every investor dollar as their own.

The prospectus and software

The attorney for private-money fund-managers drafts a prospectus for potential investors. This document will outline the types of loans to be purchased or originated; the types of investor shares offered; the frequency of distributions; servicing fees; any loss reserve; and information about the fund's management, performance fees and any other expenses.

Careful selection of a software-provider can increase private-money funds' chances of success. Software decisions often take place at the fund-establishment phase and can occur in concert with the selection of attorneys and accountants. When software is used, it should provide the calculations necessary for investor distributions. It also should conform to legal requirements and meet general accounting principles.

Questions to ask when making a software decision include:

- **Is it designed to have one capital account per investor type or entity?**
- **Does it have the ability to handle multiple types of shares and provide a history of shares purchased and sold?**
- **Can it reverse and reprocess transactions to correct user errors?**
- **Can it track accrued expenses and income and automatically include them in the distribution figures?**
- **Can it track funds received and disbursed for each client, borrower and investor?**

Financial gain

Although some private-money fundamentals haven't changed — equity still rules, for example, and the process of establishing a mortgage fund remains complex — brokers might find that the financial gain that can accompany fund management is well worth the effort.

Fund-managers can make money through origination, management, performance fees when the fund reaches a certain yield to investors, servicing fees, late fees from borrower payments, demand fees and others.

Typically, firms that service private investors' loans have the ability to work out affordable payment plans when loan defaults occur. This helps ensure that investors don't end up owning real estate they never intended to own.

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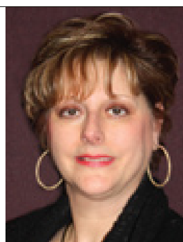

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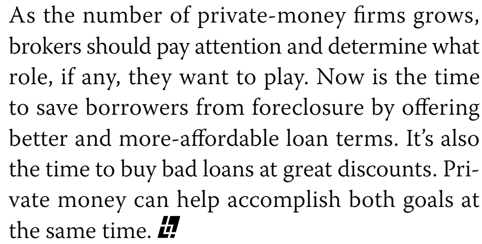
Large financial institutions could attempt the same thing to avoid foreclosures. They could modify loan terms, reduce interest rates and change adjustable-rate mortgages to fixed-rate. They also could charge a reasonable fee for such modifications. These institutions' reluctance to do so, however, increases the market for private-money funds. It also allows mortgage brokers to play a more direct role in helping borrowers afford to stay in their homes and keep other properties they own.



As the number of private-money firms grows, brokers should pay attention and determine what role, if any, they want to play. Now is the time to save borrowers from foreclosure by offering better and more-affordable loan terms. It's also the time to buy bad loans at great discounts. Private money can help accomplish both goals at the same time.

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