The Risks of Creative Financing

More than half the home sales in a recent survey involved creative financing. While creative financing may keep the selling price high, it also can leave the seller holding the mortgage—or the bag.

As mortgage rates soared in the past several years, realtors, developers, builders, home sellers, and home buyers looked for sources of funds other than traditional lending institutions. Today, the residential real estate market is focusing on "creative financing" techniques, which involve a supplier of funds in addition to or in place of a financial institution. Over half of the home sales we looked at in a recent survey of southeastern realtors involved creative financing. In 41 percent of the sales we surveyed, the seller had taken back either a first, second, or third mortgage.[1]

Our survey indicates that sellers and their realtors often ignore the less risky alternatives available to them in closing a sale in favor of maximizing the sales price. Individual mortgage holders do little credit analysis in extending loans. In a substantial number of cases, the total mortgage on a home is greater than its true market value. Judging from the realtors' experience, home prices in the Southeast are advancing slowly, homes are remaining on the market for longer periods than they did three years ago, and buyers are paying a premium (over market value) sales price to obtain "below market" mortgage rates.

Creative financing is an intermediate response to a structurally changing industry. The recent stagnation in the traditional financial markets left a gap that is being filled by an innovative, non-traditional mechanism. The basic problem with creative financing, however, is that the sellers, in providing financing, often seem more intent on consummating a sale than on making a sound investment with a positive real rate of return. For this reason, many fundamental principles of lending are ignored when the deals are constructed.

Financial institutions analyze their loans on the basis of the risk involved and the expected rate of return. Unsecured consumer credit generally will carry a higher rate of interest than a secured automobile loan. Likewise, the rates on small business loans usually are higher than the prime interest rate, granted only to the most financially secure companies. The risk premium reflected in interest rates also appears in the yields on industrial bonds of differing

[1]The Federal Reserve Bank of Atlanta sponsored a survey of realtors in eight southeastern cities in July, 1982 which was conducted by the Georgia State University Department of Economics. From responses of 80 realtors, we drew information about 333 specific sales closed in 1982. The survey is a follow-up to the one conducted by the Federal Reserve Bank of Atlanta in first quarter, 1981. See the October 1981 issue of the **Economic Review** for the results of that survey.

Chart 1. Moody's Industrials Bond Yields

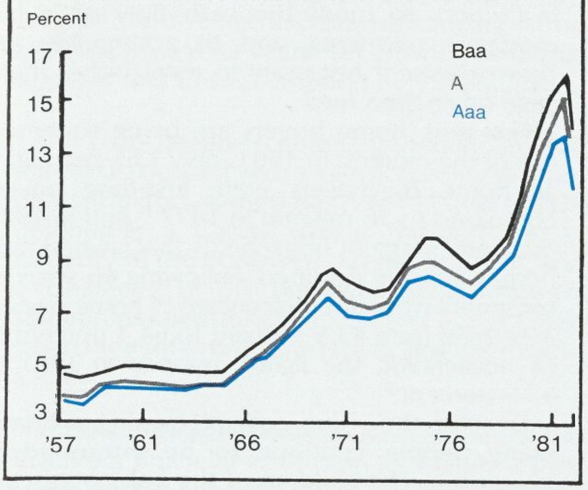
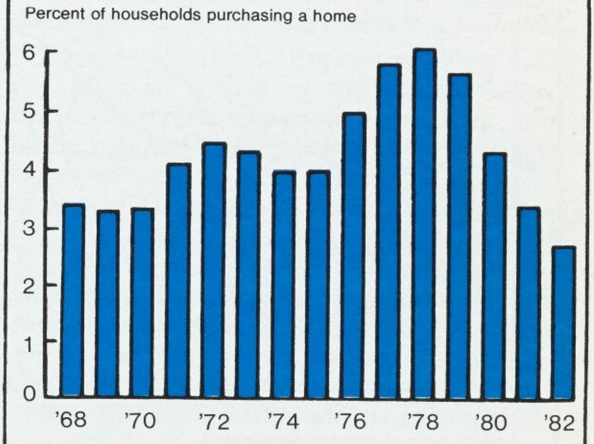


Chart 2. Frequency of Home Sales



Source: U.S. Bureau of the Census: National Association of Realtors

quality. Bonds with a low quality rating of Baa have consistently yielded more than bonds with a high quality rating of Aaa[2] (Chart 1).

Many people involved in arranging creative financing are untrained and inexperienced in the analysis of risk or return on investment. Some obvious contradictions occur when a seller accepts a 12 percent return on a second mortgage based on the same risk for which a lending institution would require an 18 percent return, or if a seller accepts a 12 percent return on a five-year balloon note when he could invest the funds in a five-year Treasury note at 14 percent.[3] A thorough understanding of the risks involved and the less risky alternative means of financing would encourage home buyers and sellers to scrutinize their creative financing arrangements more carefully.

Why Use Creative Financing?

The real estate market remains in a severe slump. From 1978 to 1982, existing home sales declined 54 percent and housing starts dropped 60 percent. The southeastern real estate market is no exception. As of July, new housing construction had declined below the late 1970s peak by 58 percent in Alabama, 48 percent in Florida, 29 percent in Georgia, 53 percent in Louisiana, 57 percent in Mississippi, and 61 percent in Tennessee.[4]

The severity of the downturn is depicted in Chart 2. During the late 1960s, the percentage of all U. S. households purchasing a new or existing home was stable at just over 3 percent. The decade of the 1970s brought a real estate boom as a greater percentage of households

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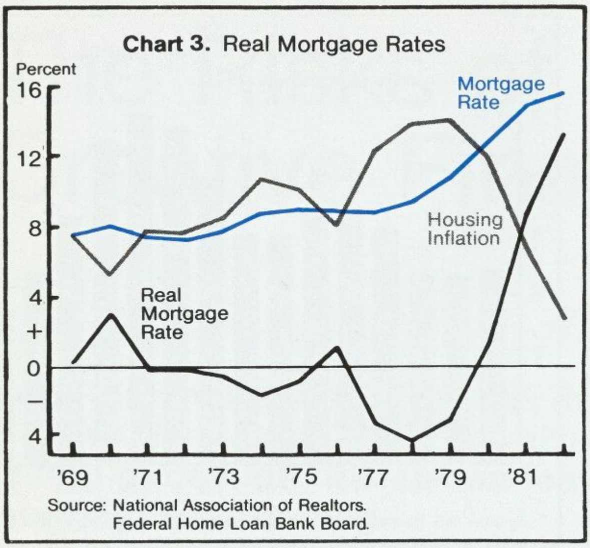
[2]Paul Samuelson explains the determination of interest rates as follows: "The market rate of interest is that percentage return per year which has to be paid on any safe loan, bond or other type of security, and which has to be earned on the value of any capital asset (such as a machine, a hotel building, a patent right) in any competitive market where there are no risks or *where all risk factors have already been taken care of by special premium payments to protect against risk*." The risk factor must be quantified in order to incorporate it into the interest rate. In **Essentials of Managerial Finance** J. Fred Weston and Eugene F. Brigham describe the traditional measure of risk as follows: "The riskiness of an asset is defined in terms of the likely variability of future returns from the asset. The tighter the probability distribution of expected future returns, the smaller the risk of a given project." Moody's describes its bond ratings: "Bonds which are rated **Aaa** are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as 'gilt edge.' Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues. Bonds which are rated **Baa** are considered as medium grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appeared adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well."

[3]In the first half of 1982, financial institutions charged an average 18 percent on second mortgages, five-year Treasury notes yielded an average 14.22 percent, and sellers charged an average 12 percent interest rate on second mortgages.

[4]Nationwide existing home sales reported by the National Association of Realtors and housing starts by the U.S. Bureau of the Census. New housing construction for southeastern states is reported in F.W. Dodge Construction Potentials.



began to buy a home each year. Interestingly, the 1973-75 recession resulted in only a short pause in the growth trend of home purchases. Even though that recession was considered rather severe for the real estate industry, the percent of households purchasing homes in 1974 and 1975 was greater than in the late 1960s. The real estate boom of the 1970s peaked in 1978 when 6.2 percent of all households bought a home. The decline in home sales since 1978 has been severe. This year only 2.7 percent of all households have purchased a home. Had creative financing not existed, it is likely that this percentage would have been even smaller.[5]

The reduced activity is primarily a function of high rates on new mortgages. When inflation in home prices was higher than mortgage rates, the real cost to the consumer of financing a home was negative. Today, the large positive differential between mortgage rates and housing appreciation has dampened consumers' ability and motivation to buy a home (Chart 3). Home buyers simply cannot afford payments implied by the current high level of mortgage rates. Double-digit rates make it more difficult for a borrower to qualify for a loan from a financial institution, to meet the cash flow of higher mortgage payments, and to accumulate the down payment necessary to meet higher mortgage origination fees.

First-time home buyers are being squeezed out of the market. In 1981, only 13.5 percent of all home purchasers were first-time buyers compared to 36 percent in 1977.[6] And in 1981 the percentage of households that owned their homes actually declined. Following 40 years of prosperity when the percentage of home owners increased from 43.6 percent to 64.4 percent of all households, the figure dropped in 1981 to 63.6 percent.[7]

Despite the rising cost of owning a home, many people continue to be interested in ownership. The children of the baby boom are now in their early 20s to early 30s. Many have delayed marriage and family and are just now beginning the search for their first homes. They grew up in single-family suburban homes and want the same or better for their families. Mobile families expect to be able to change jobs and buy a home anywhere in the country virtually at will. Additionally, people have come to believe that housing is the best investment they can make based on rapidly rising home values and the income tax deductions allowed for interest expense and property tax payments.

While these trends are beginning to be reversed, potential home buyers' expectations have motivated them to search for affordable housing and have encouraged sellers to find means of providing affordable housing. To bring the cost of housing within reach, buyers and sellers have compromised on financing techniques rather than on price. The reasons for this choice appear to be the realtors' desire to preserve sales price and the sellers' preoccupation with the appreciated value of their homes.

Risks of Creative Financing

Creative financing might be less popular today if buyers and sellers were aware of all the risks involved. The risks are of three types:

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[5] The total number of home purchasers is derived by adding the total number of existing homes sold (National Association of Realtors) plus the number of new homes sold (U.S. Bureau of the Census). The total number of home purchasers divided by the total number of households (U.S. Bureau of the Census) gives the percentage of households purchasing a home. There may be a slight upward bias in this calculation owing to multiple purchases by individual households and an upward bias in NAR reporting of sales.

[6] U.S. League of Savings Associations.

[7] U.S. Bureau of the Census.

(1) **Economic Environment**—Many creative loans are made with the assumption that resale values will continue to climb and that refinancing will be available in several years. Yet growing evidence suggests that this assumption may be faulty.

(2) **Loan quality**—Lenders generally analyze the risk associated with a loan according to three primary factors, sometimes referred to as the C's of lending: a. Capital base of the borrower, b. Capacity of the borrower to repay the debt, and c. Character of the borrower. Seller-financers sometimes fail to take these factors into account when they set a mortgage rate or agree to extend a loan.

(3) **Institutional**—Most creative arrangements involve a financial institution as well as a third party lender. The institutions are threatened by creative arrangements which attempt to circumvent their mortgages' due-on-sale clauses. Also, creative financing may overextend the buyer's total debt burden, making default on institutional-held mortgages more likely in a recessionary environment.

● Environmental Risks

The following statement from the National Association of Realtors' Real Estate Status Report, as recently as April 1982, seems to typify the creative financing "mentality." "Mortgage interest rates .... will not come down very much over the foreseeable future," it declares. "And while people wait for lower mortgage rates, home prices will be increasing. The result: Any anticipated savings in interest payments will be more than offset by the expected increase in home prices. Without doubt, delays in home buying will prove costly."

Recently, however, housing prices have been leveling off. According to the National Association of Realtors, median home prices nationwide advanced 14.4 percent in 1979, 13.3 percent in 1980, and 6.8 percent in 1981. As of August 1982, prices were up only 1.8 percent over the same period a year ago (Chart 3).

Over one-quarter of southeastern realtors who responded to our survey indicated that housing prices in 1982 are level with a year ago. Almost a full quarter of them said prices are actually lower this year. Another quarter said prices are only 1-5 percent above last year. The remainder reported a higher growth rate in home prices, suggesting a 1982 median growth rate in home values in the Southeast somewhere between 0-5 percent.

While nominal housing prices are still increasing, the gains are offset by the inflation rate as measured by the consumer price index. In real terms, national housing prices as of August were down 4.1 percent from August 1981.

Several developments suggest that the pace of growth in real estate values will not return to the double-digit levels of the 1970s. First, inflation should continue to subside in the next decade. Second, with deregulation, lending institutions are paying higher rates on deposits and must cover these costs with higher rates on loans. Housing prices will continue to be dampened by the high cost of financing. Buyers who expect much lower interest rates when they refinance balloon notes may find that rates remain unaffordable. Third, government emphasis is changing from stimulating the economy through consumption to stimulating it through savings and investment. The focus is now to "reindustrialize" America rather than to provide quality housing for all Americans. Though politically difficult, this direction has already resulted in reduced government subsidies to residential construction. There is also a movement to reduce the tax incentives to individuals who pay a high interest expense. Most industrial countries have already limited the amount of home mortgage interest which can be claimed as a deductible for income tax purposes. The proposed flat rate tax is one example that would eliminate interest expense as a deductible and could dramatically change the motivation for owning a home.

Fourth, tangible assets such as real estate are the best investments under conditions of inflation, rising taxes, political instability, and government regulation—the conditions which existed for the last decade. On the other hand, paper assets (stocks and bonds) flourish under conditions of more confidence in money, less inflation, declining taxes, a reduced role of government, growth in productivity, and a government that emphasizes investment over consumption—the conditions likely over the next decade. Residential real estate may lose its attraction as an investment. Speculators will likely leave the market. Home owners who currently consider their mortgage payment as part of their savings may find it necessary to channel their savings into more rapidly appreciating investments.

● Loan Quality Risks

About 41 percent of the sellers in our survey extended a loan to buyers in order to ease the financing burden on the buyer. These sellers made an average investment of $30,000. Most people, when investing this amount of money in any other financial instrument, would scrutinize the risk and attempt to either minimize it or to receive the maximum return for that risk. However, people who hold second or third mortgages do little to ensure the safety of their investments. The three C's of lending too frequently are ignored.

Capital—In making a mortgage, the seller should be concerned with the borrower's capital, or net worth, which includes the value of the asset (the home) securing the mortgage. A lender should never provide financing for more than the asset would be worth in a distress sale.[8] Lending institutions require an accurate appraisal before agreeing on an amount to finance. However, 40 percent of the realtors in our survey said that generally no appraisal is conducted for the individual mortgage holder (Table 1).

Table 1. Survey Question
Based on your experience, who performs the following tasks when a seller takes back a mortgage?

	Response	% of Total Responses
Appraises property	No one	40%
	Licensed appraiser	30%
	Real estate broker	24%
	Financial institution	4%
	Buyer	2%
Checks credit of buyer	Real estate broker	33%
	Seller	23%
	No one	16%
	Credit bureau	11%
	Financial institution	10%
	Lawyer	7%
Collects Payment	Seller	70%
	Financial institution	22%
	Real estate agent	6%
	Notary	1%
	Lawyer	15%

Whether a formal appraisal is done or not, the buyer, seller, and realtor place a value on the home based on comparable sales in the neighborhood. But creative financing has distorted home values. A home with an attractive financing package generally has a selling price 6-10 percent higher than homes with traditional financing, according to realtors in our survey.[9] Essentially, buyers are paying a premium sales price in order to secure lower financing costs—that is, part of the interest cost is imbedded in the sales price. However, if the buyer is forced to sell the home quickly, he may be unable to provide as attractive a financing package as he originally received. With traditional financing, the home may be worth less than he paid for it. If we consider the true value of the home to be the sales price less the premium paid for a lower interest rate, lenders are at times overextending themselves in granting mortgages which bring total mortgage debt on the home to too great a percentage of the value of the home. In the survey, 15 percent of the homes carried mortgages which totaled more than the discounted value of the home.

Capacity—The buyer's cash flow and previous history of loan payment should concern the seller in determining whether the buyer will be able to service all of his debts. In creative financing, credit checks often are casual at best. Sixteen percent of the survey respondents indicated that the buyer's credit record is not checked when arranging creative financing. Less than 25 percent of the respondents said a financial institution or a credit bureau is used to verify credit. The rest of the realtors indicated that the broker, the seller, or a lawyer—someone unskilled as a creditor—performed a credit check (Table 1).

A buyer lacking the capacity to pay eventually will become delinquent. Individual mortgage holders have little power over the borrower who gets behind on payments. During a period of high unemployment, delinquencies may mount. Mortgage loan delinquency rates at financial institutions have climbed in the last several years well above the peak reached in the mid-1970s recession. For the southeastern states, the results are mixed. Alabama, Florida, Mississippi and

[8] The term "Distress sale" as used here means a sale under conditions which require a quick sale, usually within 60 days.

[9] This estimate is substantiated by an analysis prepared by G. Stacy Sirmans and Stanley D. Smith of Emory University and C. F. Sirmans of the University of Georgia, "Assumption Financing and Selling Prices of Single-Family Homes." They developed an empirical model which shows that "holding constant other variables which affect selling price, loan assumptions carry higher selling prices than homes purchased with conventional mortgage financing."

Table 2. Percent of Total Mortgage Loans Delinquent 30 Days or More Second Quarter Data

	1982	Recent Low	Date	Recent High	Date
U.S.	5.18	4.21	2Q79	4.43	2Q76
Alabama	6.00	3.63	2Q78	5.08	2Q76
Florida	4.81	3.60	2Q79	3.86	2Q77
Georgia	5.25	5.31	2Q79	5.93	2Q77
Louisana	3.61	3.47	2Q78	3.91	2Q76
Mississippi	5.44	3.76	2Q78	5.28	2Q75
Tennessee	6.63	4.00	2Q78	4.34	2Q76

Source: Mortgage Bankers Association National Delinquency Survey

Tennessee are experiencing delinquency rates much higher than during the mid-1970s recession. Louisiana's delinquency experience is slightly better. While Georgia appears better off now than in the mid-1970s, the level of delinqency is one of the highest in the Southeast (Table 2).[10] Since unemployment generally remains high even after a recovery begins, the recession's effect on delinquencies may continue throughout 1983 and possibly into 1984.

Delinquencies are likely to be higher for seller-held mortgages. A pressured debtor will generally pay an institution before he pays an individual because he believes the consequences of default are greater. When sellers do not employ a third party to collect payments, the payment mechanism is usually fraught with late payments and casual procedures. In our survey, 70 percent of responding realtors indicated that sellers make their own collections (Table 1).

The risk is magnified if the seller is using income from the mortgage he is holding to make his own mortgage payments. Defaults and foreclosures are likely to accumulate as individual mortgage holders cannot collect from their own borrowers.

Character—The last of the three C's of lending is difficult to assess in any lending situation. Individual mortgage holders generally trust their realtors to recommend buyers of a worthy character. A credit check would give the seller some further indication of character based on the buyers' past record in repaying debt.

[10]Mortgage Bankers Association National Delinquency Survey.

● Institutional Risks

Every financial institution with a residential mortgage portfolio has been affected by creative financing. These institutions desperately need to refinance old mortgages to improve the yields on their portfolios. One objective of creative financing is for home buyers to retain those low-interest mortgages. The recent ruling that all financial institutions can exercise due-on-sale clauses will help the institutions, but "creative financers" continue to find ways to avoid activating the due-on-sale provision.[11] Installment land contracts, purchase money options, wraparounds and "silent sales" (see Box for definitions of these terms) are now being used to avoid the requirement. We asked realtors to indicate what techniques they had used specifically to avoid due-on-sale. Renting with the option to purchase was mentioned most often—by 33 percent of the realtors. The next most popular device was wraparounds, with 29 percent. Eighteen percent had used the purchase money option and 12 percent had used the installment land contract. Only 5 percent had tried a silent sale, in which a seller does not notify an institution that a sale has taken place.

Another risk for financial institutions is that borrowers may be stretching their debt burdens by obtaining second and third mortgages exceeding the value of their homes. Often the institution granting the first mortgage is unaware of the added debt of a second or third mortgage. The buyer and seller will make an informal arrangement which looks initially like a cash purchase to the first mortgage lender. The formal second or third mortgage is arranged only after the house is purchased. In the past those second and third mortgages either were unobtainable or too costly for the debt-stretched buyer. However, a borrower can get overextended today when a seller is willing to extend a loan regardless of the borrower's current debts and without notifying the institutional mortgage lender. Additional debt pressures on the borrower increase his likelihood of default particularly if family members become unemployed.

[11]Some states had prohibited enforcement of due-on-sale clauses before passage of the Garn-St. Germain Depository Institution Act of 1982. For mortgages made or assumed in those states during the "window period" (between state prohibition of enforcement and passage of the recent federal Act), enforcement of due-on-sale clauses is still prohibited.

Rate of Return

Mortgage rates fall into two categories. (1) Market Rates—rates on new mortgages that are set by the dynamics of the marketplace. (2) Below-Market Rates—rates on assumptions of old mortgages, rates on blended mortgages consisting of assumptions and new second mortgages held by an institution or an individual, and rates on mortgages held solely by individuals.

The market rates are set by the institution based on inflation expectation, cost of funds, and risk. A new first mortgage at the time of the survey (second quarter, 1982) carried an interest rate of about 16 percent. Second mortgages from institutions had interest rates averaging 18 percent. Most home sales in our survey involved financing with below-market rates. Only 17 percent of home buyers paid the "market rate of interest." The other 81 percent managed to finance their home at below-market rates using assumptions or creative financing. Sellers applied on average a 12 percent interest rate to the mortgages they took back, regardless of whether the mortgage was a first or a second.

But buyers can be deceived by the face interest rate. In most cases, a home financed at below-market rates will sell for more than homes without low-cost financing. The premium paid should be considered part of the interest cost since it is a cost above the value of the home when financing is disregarded. We asked realtors to detail their most recent sale including their estimate of the premium paid for below-market financing if such a premium existed. Then we used this information to determine the true financing costs to the buyers. Including the cost of any premiums and those mortgages financed at market rates, buyers are still only paying an average 13 percent for their mortgages (Table 3).

While the buyer appears to be getting a break in his mortgage cost, he generally assumes some risk. In the case of balloon mortgages, he will have to refinance, usually in five years. Mortgage rates then may still be prohibitive. He also accepts the risks associated with selling his home. If he cannot provide a comparable financing package for his buyer, his home's resale value may be substantially less than he paid for it.

Sellers are accepting uncompensated risk for the return on their investments. The seller may find that he needs the loaned money sooner than expected, or he may decide to invest in a higher paying instrument. In this case, he can sell the mortgage in the secondary market.

Table 3. Survey Question

Realtors were asked to indicate all financing details with regard to their last sale. From this information we were able to calculate the average interest rate paid by buyers during the time of the survey.

Financing provided by:	% of all sales	Avg. Interest Rate[1]
Institution only –	45%	13.7 %
New mortgage	17%	15.78%
Assumption	28%	12.4 %
Creative Financing	53%	12.4 %
All types	98%	12.99%

[1]Interest rate includes sales price premium paid by buyers to obtain low rate financing. Interest rate reflects sales price premium paid by buyers to obtain low rate financing. A premium was assessed only in those cases where the realtor indicated the sales price would have been lower if low rate financing had not been available. The realtor's estimate of the price differential was used as the premium. This amount was subtracted from the mortgage balance. The annual percentage rate was recalculated based on the actual payment amount and maturity but using the discounted mortgage balance. In cases of more than one mortgage, the discount was applied to the first mortgage balance only. To obtain a singular interest rate, the rates on each mortgage were averaged using a weighting technique to take into consideration mortgage balance and maturity.

In selling a mortgage, the value of that mortgage to the buyer must be determined. On a mortgage of $70,000 at 12 percent, an investor might be willing to pay $70,000 to hold that mortgage if comparable investments also yield 12 percent. However, if he could invest the $70,000 at a higher interest rate with comparable maturity and risk, he would be better off. When secondary mortgages are trading at 15 percent, a 12 percent loan can be sold only at a substantial discount.

According to the survey, sellers often find it necessary to take their losses. One-third of the realtors knew of sellers who had sold their mortgages at a substantial discount.

Additionally, the seller accepts the risk of default. If the buyer does not make payment for 90 days, the seller can foreclose, but is generally reluctant. He may not want the responsibility of selling the house again. Foreclosure is still perceived as "villainous" by society and is usually avoided as long as possible. The delay and the process of foreclosure create a cash flow problem for the lender who is depending on the income

COMMONLY USED CREATIVE FINANCING TECHNIQUES—SURVEY RESULTS

Creative financing in our survey is defined as any financial arrangement for a real estate transaction involving a non-institutional supplier of funds. The most common techniques involve the seller holding a mortgage at a below-market interest rate. Other methods include the builder or developer supplying funds, the buyer's employer supplying funds, the realtor holding a mortgage, or the seller renting or leasing the property with a purchase option. Our survey indicates that creative financing was used to fund 53 percent of southeastern realtors' home sales in the first half of 1982 (Table 4).

Seller-held mortages, which come in a variety of forms, occurred in 41 percent of residential real estate transactions in the Southeast survey. Often (26 percent of the time) the buyer assumed the existing first mortgage or obtained a new first and the seller held a second. In 9 percent of all transactions the seller held the first and only mortgage. Balloon financing, in which the mortgage's maturity is shorter than its amortization period, was used in 19 percent of all transactions In these cases, the buyer is obligated to pay the remaining debt to the seller at maturity—usually in five years.

Another form of financing which may involve the seller is the **wraparound** mortgage. The seller continues to make payments on the existing mortgage but writes a new mortgage to the buyer at a lower-than-market interest rate. The lender uses part of the buyer's payment to make the first mortgage payment and keeps the remainder for himself. Wraparounds were used in 6 percent of all transactions in the survey.

Creative financing is most commonly used for the sale of existing homes. However, builders and developers have begun to offer attractive financing packages in an effort to sell newly constructed homes. While builders are not generally in the position to hold mortgages, they may offer to **buy down** interest rates for several years to make a new home more affordable. The buyer finances through a lending institution, but his interest cost is reduced for the first few years by a lump sum payment the builder makes at closing. At the end of that initial period, the interest rate changes to some pre-indexed rate. This technique is also used by corporations to assist employees required to change job locations. Buy-downs were used in 8 percent of real estate transactions in the survey.

A special type of buy-down is the **zero interest mortgage.** A home is financed for five years through a financial institution, and the builder pays all of the interest. The buyer owns the house at the end of five years. Only two sales, or less than 1 percent of the transactions in the survey, employed this type of mortgage.

Not surprisingly, **realtors** have also begun to help out in providing financing. In nine transactions, or 3 percent of the time, the realtor provided some or all of the financing to close a sale.

Other alternatives include various forms of renting. In these contracts the buyer lives in the home and makes payment to the seller, who retains the title. One form is a straight **rental** in which the buyer makes a monthly payment. He may be given the option to purchase by a specific date, when he has accumulated a large enough downpayment, or when he can obtain institutional financing. Renting with the option to buy was used in 3 percent of the transactions in the survey.

Another form of creative financing which involves renting is the **"purchase money option."** In this arrangement, the buyer lends the seller an amount up to the seller's equity as a second mortgage on the property. In return, the seller gives the buyer an irrevocable option to buy for a period of between three and five years. The buyer pays rent to the seller until he can obtain adequate financing and exercise his option to buy. The purchase money option was offered in only two cases, or less than 1 percent of the survey transactions.

A third alternative that looks like a rental is the **installment land contract.** The buyer makes installment payments to the seller who retains title to the property. At the end of the installment period, the buyer must obtain the financing to buy the property. During this time, the buyer accumulates no equity in the home, but he is able to deduct the payments from his tax liability as interest expense. Only three, or about 1 percent, of the survey transactions used this approach.

Barter is another possible means of a buyer providing something of value to a seller. This approach was mentioned in one transaction in the survey.

Table 4. Southeastern Residential Real Estate Survey Financing by Source January-June, 1982

		Number of Sales		% of Total Sales
Cash		8		2%
Financial Institution only		150		45%
Creative Financing[1]				
Seller-Financing				
2nd Mtg without balloon	41		12%	
2nd mtg with balloon	47		14%	
1st Mtg without balloon	13		4%	
1st Mtg with balloon	17		5%	
Wraparound	19		6%	
Buy-downs				
Partial	22		7%	
Zero-interest Mtg	2		1%	
Realtor	9		3%	
Barter	1		0%	
Rental Alternatives				
Rent/Lease w/option to buy	11		3%	
Purchase money option	2		1%	
Installment land contract	3		1%	
		175		53%
		333		100%

[1]Creative financing is defined as any financial arrangement facilitating a real estate transaction which involves a noninstitutional supplier of funds. For example, a straight assumption of a low rate mortgage at a savings and loan would not be considered creative financing. An assumption plus a second mortgage held by the seller would be considered creative financing.

from the mortgage. Even after foreclosure proceedings begin, the process may take another nine months to finalize. The seller must be financially able to forego his income and make the first mortgage payments during foreclosure proceedings and until he can resell the property.

At lending institutions across the nation three-fourths of the mortgages delinquent 90 days or more were in foreclosure in mid-1982. In the Southeast, however, foreclosure is less common. Only 40 percent of defaults are being foreclosed in Alabama, 48 percent in Florida, 58 percent in Georgia, 56 percent in Louisiana, 42 percent in Mississippi and 52 percent in Tennessee.[12]

Alternatives

Many of the loans arranged outside traditional credit markets have a thin margin of error. The risks that buyers and sellers take in creative financing increase the likelihood of real estate losses in the next few years.

Compare seller-financing of a home with seller-financing of an automobile. We do not generally think of housing and automobiles in the same way with regard to financing. Houses have tended to **appreciate** in value; automobiles **depreciate** in value. Yet there are attendant costs to owning a home similar to the depreciation costs of automobiles. Houses are subject to some technological obsolescence requiring the replacement of heating and air-conditioning systems, for example. Likewise, new model cars are more efficient and technologically advanced than older models. Weather conditions wear on a home, requiring frequent painting or possibly roof replacement. Automobile bodies reflect age and exposure to the elements. Homes require insurance against natural disasters just as casualty insurance is required in owning an automobile. Daily living and traffic through a home wears out carpets, draperies and appliances which must be replaced. Likewise, automobile engines and interiors eventually degenerate.

If an individual were asked to finance the sale of his used Cadillac at 12 percent for $15,000, he would probably decline giving reasons such as: "The car may not hold its value over the life of the loan. I have no means to insure the buyer will make timely payments. I need the cash to buy a new car. I could invest the cash at the same interest rate somewhere else with less risk of loss. If the buyer does not maintain the car, my collateral loses value." Creative financers should examine their transactions in this same light.

There **are** other alternatives for financing homes that buyers and sellers should recognize. The first is to negotiate based on effective sales price rather than financing terms. The second is to work closely with a financial institution to obtain a financing package comparable to what sellers are offering.

In our survey, there were several cases where simply lowering the price of the house would have affected neither the buyer's cost nor the seller's return. In these cases, the buyer could finance a smaller sum through a financial institution at a higher interest rate while making the same monthly payment. He would be better off, in fact, since he would pay a relatively higher proportion in interest, which is tax deductible. Although the seller would receive a lower price, he would be able to invest the cash he received at a higher interest rate with less risk and greater liquidity.

The tax effect often is not considered by buyers who pay a sales price premium to secure lower financing costs. To obtain favorable financing, the buyer might offer to pay the seller discount points instead of a sales price premium. As long as the number of points is reasonable and comparable to points charged by financial institutions, the buyer's points expense will be tax deductible. If instead these discount points are labeled part of the sales price, as is generally the case, the buyer foregoes his immediate tax benefit. Sellers may object because discount points are taxed as interest income, whereas the sales price received would be taxed as capital gains. Nevertheless, both buyers and sellers should be aware of the tax consequences when negotiating a financial arrangement.

In financing a newly constructed home, the buyer might consider carrying the builder's construction loan and allowing the builder periodic advances on a percentage completion basis. The home buyer saves the builder the cost of financing by getting advances directly from the financial institution. For the buyer, advantages are threefold: 1) he is able to deduct from his adjusted gross income the interest expense normally added to the builder's construction cost thus reducing his tax obligation; 2) the buyer is able to assume the builder's construction loan, assuming

[12]Calculated from data reported in Mortgage Bankers Association National delinquency Survey.

his credit status permits; 3) and finally, the buyer is able to wait for a lower interest rate rather than have to renegotiate a new mortgage at a future time. At the same time, this arrangement permits the builder the opportunity of actually lowering the fixed price of the contracted home, since he incurs no borrowing costs, and it passes the tax advantage directly to the party who can benefit most.

Home buyers and sellers also are now offered many more options through local financial institutions. Often buyers can obtain the same rates that sellers are willing to accept by using alternative mortgage instruments. For sellers, risk is eliminated when they can avoid holding a mortgage.

Summary

Creative financing is a response to the past few difficult years in the real estate market. Sellers accept the risks involved because they believe that taking back a low-rate mortgage will sustain the value of their home and that its value will continue to appreciate. Buyers cannot afford the cost of financing new mortgages. Realtors have become increasingly innovative in an effort to continue making sales.

Financial arrangements today are often made with insufficient regard to risk. Loans are made to accomplish the objective of selling a home with little concern for the soundness of the investment. Changes in the housing market in general may dampen the investment value of homes. The assumption that housing will continue to appreciate at double-digit rates may prove incorrect, leaving lenders with over-valued investments. Selling prices are inflated by the attractiveness of the financing package. Often the total amount of the mortgage is greater than the value of the home under distress conditions. Loan quality is questionable in creative financing since the lender does little credit analysis. Collections may become a problem for seller-financers as delinquencies swell. Sellers suffer substantial losses if they choose to sell a low-rate mortgage on the secondary market or if they are forced to foreclose.

As publicity mounts about disappointing creative financing deals and as consumers are offered more financing alternatives, buyers and sellers will learn to make wiser decisions. Sellers do not have to hold mortgages to attract buyers. Accepting a lower sales price may be worth the freedom from holding a mortgage. Financial institutions increasingly are offering mortgage instruments that accommodate buyers' needs. When the seller does decide to hold a mortgage, he can make more formal arrangements for analyzing the buyer's credit-worthiness, appraising the property, and servicing the loan. Paying a small fee to obtain professional, expert services and advice may avoid losses later.

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