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Technical Report

Retail Property Financing

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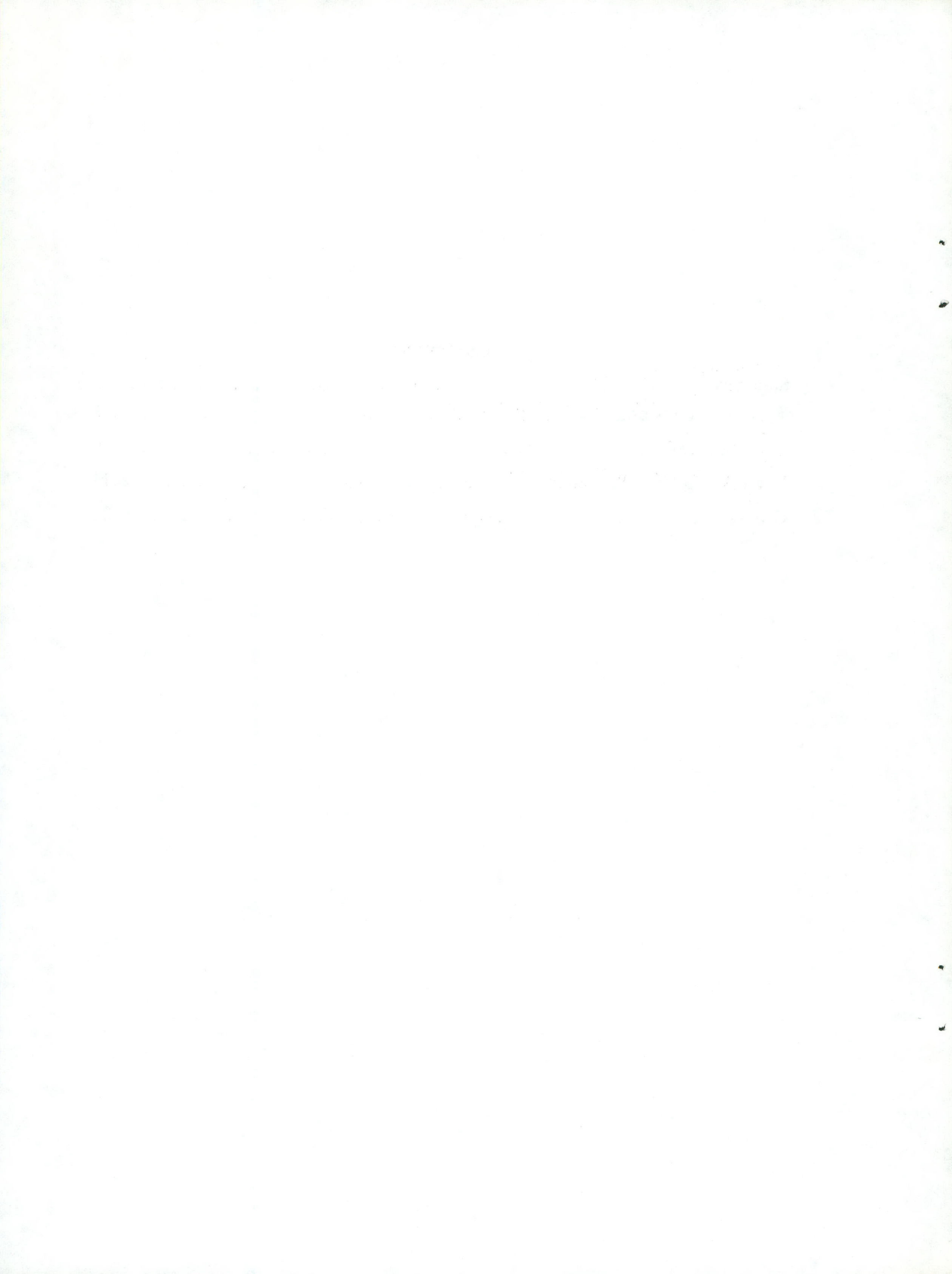
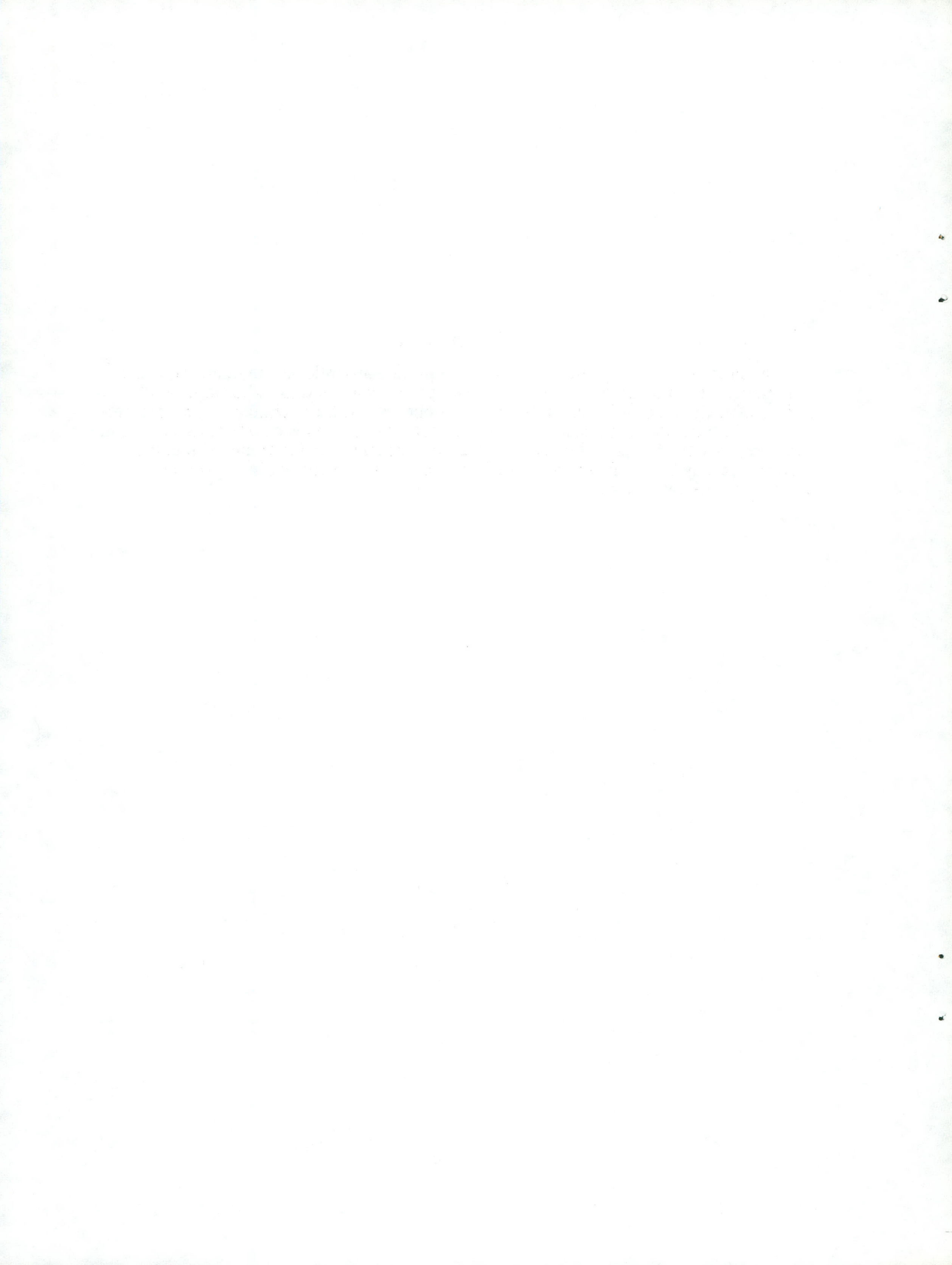


Summary

This technical report presents information particularly relevant to financing retail properties, including equity sources, income-property loan types, advantages and limitations of each and relative costs. Prospective lenders and their lending criteria are provided. Also, the loan application and documentation process is detailed, including steps leading to loan closing. A brief list of standard contract provisions and negotiable options that may be available are presented with an assessment of the impact on borrower risk by each one.



Real estate is seldom purchased as an all-cash transaction. In most instances, a large portion of the purchase price is financed by borrowing. The borrower is faced with the task of finding the loan that fits specific needs and locating a lender who originates that type of loan. From the borrower's point of view, there are four principal questions to answer. First, "What types of loans are customarily offered for retail property financing?"; second, "Which lenders are good sources for a loan that best fits the borrower's unique needs?"; third, "What documentation is needed to get a loan?"; and finally, "What loan terms may be negotiable?"

This report is a borrower's guide for selecting a loan type, identifying a lender and understanding the intricacies of the lending process. Borrower and lender objectives are summarized as are the options for ownership vehicles and financial arrangements. Lenders are categorized by the types of loans offered and their lending criteria. Finally, the lending process is traced from loan submission through processing, underwriting and closing. A glossary of financing terms is included. The effect of income taxes on a financing option is not considered. Because there are major revisions in the Internal Revenue Code as a result of the 1986 Tax Reform Act, readers may want to consult a competent tax adviser.

Types of Loans and Ownership

Changes in the asset management of financial institutions, particularly savings and loan associations (S&Ls), occurred as a consequence of double-digit inflation in the 1970s and subsequent deregulation. The result has been a trend toward short-term non-residential loans to hedge interest rate variability and to shift some risk to the borrower. Mortgage market turbulence during the late 1970s and the 1980s led to a change in loan types among traditional lenders.

Innovative loan structures emerged following deregulation. Competition among lenders produced a wide variety of loan structures generally not offered prior to 1979, and more financing sources became available. Money markets have become internationalized with large sums of foreign investment capital entering the United States. Thus, the loan market has become more complex since 1975. Consequently, prospective borrowers knowledgeable about mortgage market changes may improve their position.

A mortgage is the traditional method for financing real estate. The fee owner (mortgagor) offers the property as security to the lender (mortgagee) while retaining beneficial ownership. Financing techniques are varied and are limited only by the lender's policies. Lending arrangements range from a fixed interest rate level payment fully amortizing mortgage (conventional) to loans with variable interest rates, interest-only with balloon payments, participation in property income and equity or joint venture transactions in which the organizing partner's only investment may be expertise.

Both the equity and debt financing are important considerations. Debt financing

includes three basic considerations: the type of loan, the loan terms and the financing structure. The types of financing, subdivided into equity, seller and third-party financing, are summarized in Table 1. The characteristics, use and the important advantages and disadvantages to the borrower of each type of financing are described in this section.

Equity Financing

There are several types of equity arrangements with different property rights, contral over decisions and amount of equity buyers contribute.

Buyer—sole proprietor rights and decision maker.

Land lease—ownership rights reduced; purchase price, equity and financing reduced.

Partnership—property rights and equity dependent on negotiated share for each partner; partners share authority except in syndication where syndicator is general partner and decision maker.

Syndication: joint venture—similar to partnership; organizer is generally operating partner; makes decisions while venture partners are usually passive.

To select a form of ownership, the buyer considers the overall return to operation less periodic payments to the lender, less any land rental and less any periodic payments to partners to determine the return to buyer. If the rate of return on buyer's invested equity is less than that on other opportunities, then the buyer should look for ways to restructure the equity position and debt financing to increase the rate of return or explore another investment.

If the rate of return to buyer is less than the lender's rate of return on the mortgage (most analysts use the mortgage constant in the degree of leverage measure), the enterprise is operating under negative leverage (see Glossary). Two problems are evident. First, the debt coverage ratio (DCR) may be less than lenders require. Second, the lender will earn a better return than the retail property owner, not a desirable situation. A typical retail property investment example is presented in Table 2 to indicate financing variables that lender and borrower will consider. This example is used in the report to demonstrate the effect of various financial arrangements on returns.

Seller Financing

Seller financing can be a whole loan or a second mortgage. A whole or purchase loan means the seller takes back a purchase money mortgage for the difference between buyer's equity (down payment) and the purchase price. Generally, the seller will offer financing at a higher loan-to-value ratio and a lower debt coverage ratio than financial institutions. The seller may take back a second mortgage for the difference between the outstanding mortgage plus buyer's equity and the purchase price. In most second mortgage financing, the seller will prefer to join a wraparound mortgage with the outstanding property financing.

Purchase Money Financing

If a buyer has difficulty obtaining a loan from a third party, and the seller is anxious to sell the property, the seller may finance the debt portion of the sales price

Table 1. Types of Financing

Equity	Seller	Third-Party
Buyer	Purchase money	Permanent loan
Land lease	Wraparound	Interim or miniperm
Partnership		Bullet loan
Syndication—joint venture		Second mortgage
		Wraparound
		Permanent loan (participation)
		Convertible loan (first and second mortage)
		Debt-equity joint venture

with a purchase money mortgage. For such an agreement, the seller could insist on a higher-than-market interest rate on the loan as compensation for assuming risk. Furthermore, the seller could insist on an adjustable rate mortgage (ARM) to hedge against the impact of inflation and market interest rate volatility during the life of the loan. The loan terms and repayment schedule may be any arrangement agreeable to both parties.

Wraparound Mortgage

A wraparound mortgage is desirable for a buyer when the terms of the existing mortgage are attractive and the seller will finance a second mortgage. Higher-than-market purchase price and interest rate may be required to compensate the seller or the risk inherent in the second mortgage.

The example in Table 3 shows the economic benefits and demonstrates the wraparound mortgage. Assume that the total debt financing required is $1,000,000 and that the outstanding balance on the existing mortgage is $750,000 with a remaining term of 15 years at 9 percent interest. The market interest rate on a second mortgage is 11 percent. The seller will provide wraparound mortgage financing on $1,000,000 for 15 years at an interest rate of 10

Table 2. Characteristics of a Typical Retail Property Investment

Physical

- Land. one and one-third acres (about 58,000 square feet)
- Building. about 24,000 square feet
- Parking. about 300 feet by 75 feet
- Ratio building to land. (24000/58000) = .4
- Parking ratio. 1.0 - .4 = .6

Financial

- Total cost. $1,500,000
  - Land. $300,000 or about $5.15 per square foot
  - Building. $1,200,000 or about $50 per square foot
  - Overall cost per square foot of leasable space. $62.50
- Retail investor cash-on-cash yield range. 8 to 12 percent
- Investment variables. (per square foot of leasable space)
  - Total receipts. $10.50
  - Operating expenses. $3.67 (35 percent of receipts)
  - Net operating income. $6.83 (65 percent of receipts)
  - Yield. (24,000 x $6.83) = $163,900
    - ($163,900/$1,500,000) = 10.93 percent
- Invested capital.
  - Equity. $500,000 (33 percent of purchase price)
  - Debt. $1,000,000 (67 percent of purchase price)
- Market lending terms.
  - Loan-to-value ratio. .67
  - Interest rate. 9 percent
  - Length of term. 20 years
  - Annual debt service. $107,970
- Financial leverage position.
  - Annual mortgage constant. .108
  - Positive leverage (slight)

percent. The buyer makes the payments on the $1,000,000 wraparound mortgage to seller who then makes required payments on the existing $750,000 loan. The difference between the two payments is seller's return on the actual amount borrowed from the seller ($250,000). Seller's rate of return on the actual amount the buyer borrowed is 15.1 percent, nearly four percentage points above the market interest rate for second mortgages.

There is a pitfall for the buyer if the buyer-seller deal was structured to prevent the existing mortgage lender from learning about the property sale and from exercising rights under a due-on-sale clause in the existing mortgage lien. To protect the buyer's interest, the buyer needs to ensure that the seller makes existing mortgage payments to preclude foreclosure by the original lender. Such an arrangement would have to include the first mortgage lender as a party. A less risky and more manageable arrangement for the buyer exists when the seller wants to retain an assumable existing mortgage on the property to gain economic advantage from wraparound financing. If the first mortgage contract rate is above the current market interest rate, the existing mortgage lender may be willing to waive the due-on-sale clause provisions.

Third-Party Financing

The types of third-party financing listed in Table 1 may be grouped into three categories: those in which property and earning rights are retained by the buyer (permanent loan, miniperm, bullet loan, second mortgage and wraparound); those in which some earning rights are relinquished (permanent loan with participation); and those in which some property rights are relinquished (convertible loan on either first or second mortgage and debt-equity joint venture).

Property and Earning Rights Retained by Borrower

A permanent, miniperm, bullet, second mortgage or wraparound loan has no claim on economic benefits from the property. The borrower must make periodic loan payments, and the property purchased is the security on loan. The lender may require the borrower to assume personal liability to repay the loan as additional security. Each of these loan types might be structured to pay interest only for a specified period followed by loan amortization.

Permanent loans (first mortgages) are underwritten for the longest term, usually 15 to 25 years and are either fixed rate or adjustable rate loans. The loan is fully amortized. If the borrower has a fixed rate loan, refinancing may be quite expensive; permanent loan notes may have a prepayment penalty, further increasing refinancing costs. The availability of a long-term fixed rate loan is dependent on the supply of long-term funds. For optimum asset management, institutions match the duration of funds deposited by savers or investors with the duration of funds invested in loans. When long-term deposits are plentiful, institutions offer long-term fixed rate mortgages.

Table 3. Wraparound Mortgage Financing

Total amount to be financed	$1,000,000
Less existing mortgage balance	750,000
Equals new financing by seller	250,000
Wraparound mortgage	1,000,000
Terms: 10 percent for 15 years	
Buyer's annual payment on wraparound	128,955
Seller's first mortgage annual payment	91,285
Seller keeps as annual payment on new financing	37,670

For borrowers, the adjustable rate mortgage (ARM) is riskier than a fixed rate loan because large rate index increases can raise the periodic payment significantly. For example, on a loan of $1,000,000 an increase from 9 to 11 percent changes the annual payment on a 20-year note from $107,967 to $123,863, a 14.7 percent increase. Typical ARM contract interest rates are initially discounted one to two percentage points below interest rates on fixed rate loans because most of the interest rate risk is shifted to the borrower. On the other hand, if interest rates fall, the borrower's annual payment is reduced.

Bullet and miniperm loans, modifications of permanent loans, have similar structures. Bullet and miniperm loans generally have shorter terms than permanent loans. The bullet loan is often determined by the expected holding period of the investment. Terms may be from three to 20 years—the longer the term, the higher the rate. The amortization term is always longer than the loan term. The balance must be paid in a lump sum at the end of the loan term, creating a balloon payment or "bullet." To meet the balloon payment, the borrower must refinance the outstanding debt or sell the property and use the proceeds to liquidate the mortgage.

The borrower may want a bullet loan to lower periodic mortgage payments and increase annual cash flow. If the buyer is convinced that when the balloon payment becomes due, financing costs will have declined and refinancing will be available, a bullet loan may be appropriate. When the balloon payment becomes due, the borrower risks the possibility of a poor market or expensive or unavailable refinancing.

Miniperm loans are for short periods (usually two to seven years). Interest rates are high (about two percentage points above the prime rate) and typically are readjusted each time the prime rate changes. (The prime rate is usually about two percentage points greater than short-term treasury bill yields.) Amortization is long term (possibly 30 years); consequently there is a balloon payment. The risk associated with miniperms is similar to bullet loans except that it is more immediate. Miniperms should be considered as a last resort because they entail the greatest risk to the borrower.

Second mortgages and wraparound mortgages are both junior to a prior or first mortgage. Each is structured differently. A second mortgage is used to finance property after first mortgage financing has been arranged. The first mortgage could be financing assumed from the seller or a mortgage with favorable terms but a low loan-to-value (L/V) ratio. In either case, the buyer wants additional debt capital to lower the equity capital requirement. Because of the second position in a claim on the security, e.g., the property, both the lending risk and the interest rate are higher than on a first mortgage. Second mortgage interest rates may be one to three percentage points above first mortgage interest rates, and the mortgage structure may be similar to a miniperm loan; e.g., a balloon payment usually will be due at the end of a short loan term. The advantages and risk to the borrower are similar to those for the miniperm.

If the first mortgage has favorable terms, a wraparound mortgage may be preferable to a second mortgage. The structure is identical to seller financing. However, the seller may want to be paid in full to sever connection with the property. An assumable existing mortgage with favorable terms has advantages for a third-party second mortgage lender offering wraparound financing. As shown in the wraparound example discussed under seller financing (p. 3, 4), the borrower may be able to increase the amount of the second mortgage loan to an L/V ratio of perhaps 75 percent, reducing the buyer's equity capital requirement. As an alternative, if a separate second mortgage only increases debt financing to an L/V of 67 percent, the wraparound financing is still beneficial if the buyer's before-tax return on equity (ROE) is increased.

For example, assume an existing mortgage of $750,000 with a remaining term of

15 years at an interest rate of 9 percent. The market interest rate on first mortgages is 9 percent and a $250,000 second-mortgage is available at 11 percent for 15 years. A $1,000,000 wraparound mortgage can be obtained at 10 percent interest for 15 years. Using the existing mortgage and a second mortgage for debt financing, the buyer's before-tax ROE is 7.7 percent ($38,518 cash flow divided by $500,000 equity). Using wraparound financing, the buyer's before-tax ROE is 7 percent ($34,947 cash flow divided by $500,000 equity). Wraparound financing may involve higher risk (a $128,953 annual payment on wraparound financing compared to $125,382 annual payment on the combined existing and second mortgage financing).

Earning Rights Shared with the Lender

The borrower gives up rights to a portion of annual earnings in a participation loan. To evaluate such a loan, the borrower compares the value of rights given up to the reduced risk and increase in rate of return.

Participation mortgages, often referred to as equity participations (a misnomer), provide an inflation hedge to the lender as compensation for possible increasing market interest rates. The participation mortgage operates in a manner similar to an ARM if market interest rates increase. The assumption is that inflation will increase the property income generated. The amount of return for participation is based on an annual debt service (DS) payment plus a percentage of gross income or net operating income (NOI) greater than a specified level. Lenders prefer to use gross income because values are easier to validate by audit. Assume a $1,000,000 fixed rate loan at a 67 percent L/V and a 9 percent interest rate for 20 years. The annual DS payment is $107,970. Assume gross income is $252,000 and NOI is $163,800 per year. The participation might require an additional payment of 10 percent of gross income in excess of $200,000 per year.

A second application of a participation mortgage is to meet a lender's DC ratio minimum criteria when NOI is too low. Assume for the loan example above, the lender estimates NOI to be $130,000, providing a DC ratio of 1.2. However, the lender's minimum DC ratio is 1.25. The loan could be structured at an interest rate of 8.48 percent (DS payment of $104,000) and include a 20 percent participation in excess cash flow. Excess cash flow is defined as cash flow after the DS payment or NOI-DS. If the NOI during a given year is actually $130,000, then the lender would be paid an additional $5,200 (20 percent of the difference between $130,000 and $104,000). The participation percentage represents additional payment for the lender's perceived risk in lending at a below market interest rate.

Some Property Rights Relinquished

A convertible loan or a debt-equity joint venture transfers a portion of the property equity interest to the lender. In addition to reducing the borrower's property interest, the structure also might assign property operational risk or financial risk to the borrower rather than to the lender's increasing equity.

A convertible mortgage is another means of developing a lender hedge against inflation. The future amount of benefits to be received by the lender is determined in the convertible mortgage contract. Two convertible mortgage structures are possible, one based on the loan amount and the other based on a partial equity position that the lender assumes when the loan is closed. Assume that the fixed rate portion of the loan is for $1,000,000 at 9 percent for 20 years. Assume in the first case that equity is converted to the lender at the rate of .2 percent of the outstanding loan balance per year. At the end of the first year, lender's equity would be $2,000 (.002 times $1,000,000) and borrower's equity would be $1,500,000 less $2,000, less the loan outstanding balance. The equity position would be readjusted each year accordingly.

In the second case, assume that the lender makes the $1,000,000 loan and also contributes $100,000, taking a one-fifth interest in the equity. Also assume that the conversion rate is 2 percent of the lender's current equity position so that lender's equity at the end of year one is $102,000 and $104,040 at the end of year two and so on. In both cases, the lender also receives a proportional equity share of all benefits that accrue to the equity position. The debt-equity joint venture is a special case of the second convertible mortgage example in which the conversion rate is zero; the lender takes an initial equity position that does not change during the life of the venture.

Typical terms and interest rates are presented in Table 4 and Figure 1. Lenders' terms classified by type of financing are in Table 4. The loan-to-value (L/V) ratio usually limits the maximum loan amount when interest rates are low. When interest rates are high, the debt coverage (DC) ratio generally limits the maximum loan amount. For conservative lenders, the L/V ratio usually ranges from 65 to 70 percent. Lenders less averse to risk may use an L/V ratio of 75 to 80 percent.

The interest rate structure of commercial real estate finance markets and the relative cost of borrowing are outlined in Figure 1. The interest rates are presented relative to three-month treasury bill rates which are usually considered risk free. The three-month treasury bill yields are usually two percentage points below the prime rate. A fundamental risk-return relationship exists. Higher interest rates are required to compensate the lender for increased risk caused by the longer term of a mortgage, reduced borrower net worth on a recourse loan, reduced quality of the income stream supporting debt service (DS) payment or reduced DC ratio, reduced quality of a property as collateral or increased L/V ratio, or increased volatility of interest rates influenced by inflation. The position of each loan type shown on the risk-return line in Figure 1 indicates the risk in terms of the interest rate usually charged by the lender. The interest rates represent the variability of 1985-86.

Table 4. Terms by Loan Type

Loan Type	Debt Coverage Ratio	Points and Fees [1]	Loan Term (yrs)	Amortization Terms (yrs)[2]
Permanent	1.05 to 1.20	1/2 to 2	10 to 15	less than 30
Miniperm	1.05 to 1.20	1/2 to 2	2 to 7	less than 30
Bullet [3]	1.10 to 1.20	0 to 2	3 to 25	0 to 30
Second [4]	1.10 to 1.20	1/2 to 2	2 to 7	10 to 30
Wraparound	1.10 to 1.20	1/2 to 2	2 to 7	various [5]
Participation	1.05 to 1.15	0 to 1	10 to 15	less than 30
Convertible	1.05 to 1.15	0 to 1	5 to 10	less than 30
Joint Venture	1.15	0 to 1	10 to 15	25 to 30

[1]Points and fees are a percentage of loan amount.

[2]When conservative institutional lending practices apply, borrower will be required to amortize the loan.

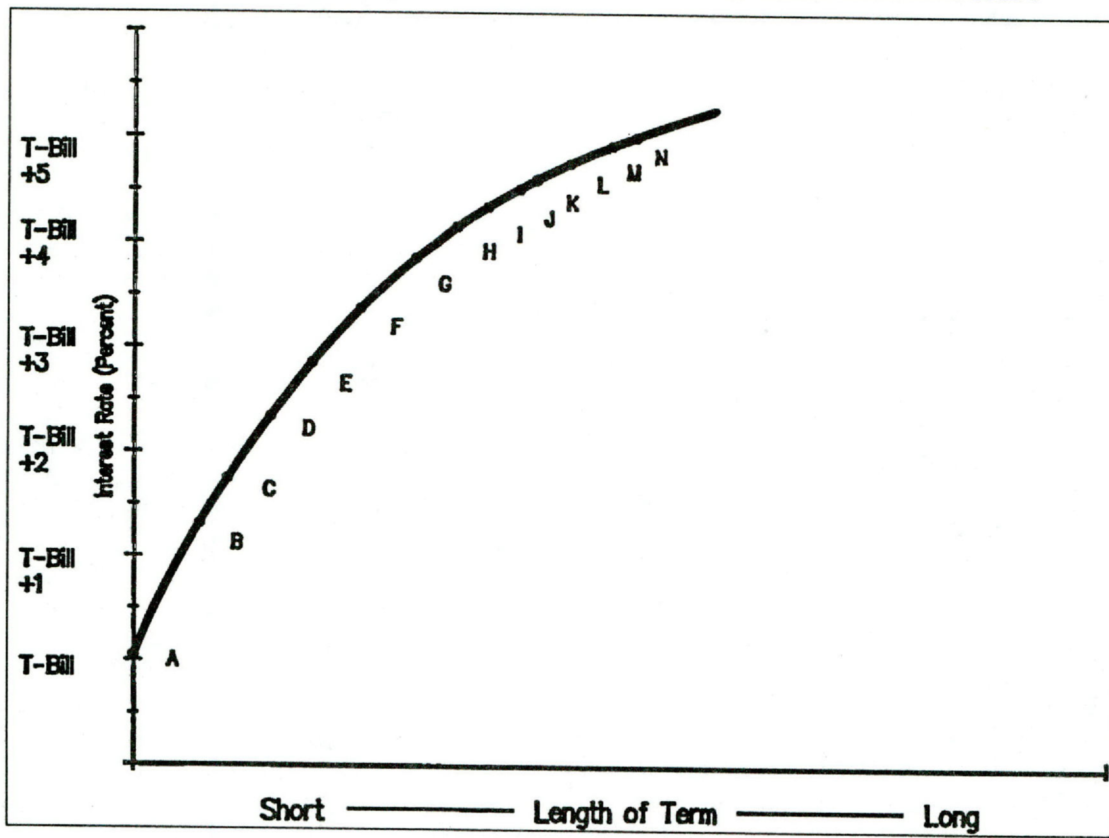
[3]Borrower generally is not permitted to prepay the loan (locked-in), precluded from transferring property title, not permitted to place junior financing on or in any other way change title encumbrance during the loan term.

[4]Loan-to-value ratio is 65 to 75 percent and prepayment of the loan is not permitted; small loans by third parties usually require the borrower's personal liability on the note; most loan terms are less than five years; if the loan term is less than five years, then terms are usually interest only.

[5]Generally long term.

Sources: George J. Fantini, Jr., "Real Estate Finance Databank," ***Real Estate Finance Update***, Boston: Warren, Gorham & Lamont, June 1985 through October 1986; Urban Land Institute, ***Dollars and Percent of Development Finance***, second quarter through fourth quarter 1984, Washington, D.C., 1985; and Real Estate Center at Texas A&M University, telephone survey of 22 large Texas financial institutions (five CBs, nine S&Ls and eight MBs), 1986.

Figure 1. Real Estate Financial Market Interest Rate Risk Structure



Key

A. Three-month treasury bills
B. Five-year treasury securities
C. Federal Home Loan Bank cost-of-funds index
D. Commercial bank prime rate
E. Three-year bullet loan
F. Five-year bullet loan; Participation loan—range is **bill +2.6 to +3.9 percent, lender required loan** investment yield T-bill +6.1 to +7.1 percent, lender participation in net income and property residuals range 25 to 50 percent; Miniperm—adjustable rate, range is T-bill +2.4 to +4.4 percent depending on quality of property income stream; Convertible—range is T-bill +2.9 to +3.9 percent, lender required yield on loan investment is T-bill +5.9 to +7.4 percent, incorporates right to convert mortgage to equity
G. Seven-year bullet loan
H. Debt-equity joint venture—range is T-bill +3.4 to +6.1 percent, required yield on debt-equity joint venture partner position is T-bill +6.4 to +8.4 percent.
I. Ten-year bullet loan; Miniperm—fixed rate, range is T-bill + 3.9 to +4.9 percent depending on quality of property income stream
J. Fifteen-year bullet loan
K. Second mortgage—adjustable rate, range is T-bill +3.9 to +5.4 percent
L. Twenty-year bullet loan
M. Wraparound—blended rate to yield range of T-bill +5.9 to +7.9 percent
N. Second mortgage—fixed rate, range is T-bill +4.4 to +5.9 percent

Sources: ***U.S. Financial Data***, Federal Reserve Bank of St. Louis, Federal Home Loan Bank Board *News*; George J. Fantini, Jr., "Real Estate Finance Databank," ***Real Estate Finance Update***, Boston: Warren, Gorham & Lamont, June 1985 through October 1986; and Real Estate Center at Texas A&M University, telephone survey of 22 large Texas financial institutions (five CBs, nine S&Ls and eight MBs), 1986.

Loan Sources

A borrower should evaluate all possible credit sources to gain the most favorable terms. Lenders and their general lending criteria are presented in Table 5. Mutual savings banks (MSBs) and sellers are not included. MSBs do not constitute a significant loan source for Texas commercial properties.

Seller Financing

The seller who wants to get out of the management business and into a relatively fixed income investment is an excellent source of credit. The seller may provide debt capital for that portion of the purchase price that the buyer is unable or unwilling to provide in cash or through borrowing from a third party. The seller's criteria may be less restrictive than third-party lender's minimum criteria. Also, the property under consideration may be undesirable collateral for a third-party loan.

The Urban Land Institute (ULI) 1984 survey noted that seller financing included both fixed rate and floating rate (ARM) loans. The average floating rate for loans in the survey was the prime rate plus 2 percent. The average data reported in the survey included an L/V ratio of 40 percent, a loan term of four years with a 25-year amortization schedule and a debt coverage ratio of 1.11.

Mortgage Bankers

Mortgage bankers originate but usually do not invest in mortgages. The mortgages originated are sold to secondary market investors. There is an active secondary market in multifamily property mortgages. However, the secondary market in commercial property is neither well developed nor active. Some mortgage bankers participate in securing commercial mortgages selling income securities to investors. Most mortgage bankers have established financial relationships with secondary market investors to originate long-term commercial whole loans that meet investor requirements. The minimum requirements vary over time and with individual secondary market investors, depending on the secondary market investor's current needs.

Real Estate Investment Trusts

About 70 real estate investment trusts (REITs) throughout the United States originate or purchase mortgages. The National Association of Real Estate Investment Trusts reported assets in 1986 to be 25.2 percent mortgages and 34.9 percent equities. The mortgages were characterized as long-term secured permanent loans, some with participation and convertible features. Most loans required regular amortizing payments. During periods of inflation, REITs preferred to invest in bullet loans.

To determine the name, address and telephone number of mortgage REITs, refer to the National Association of Real Estate Investment Trusts (NAREIT) *Membership Directory* or contact NAREIT, 1101 17th Street N.W.,Washington, D.C., 20036-4704. Telephone 202-785-8717.

Pension Funds

Pension funds are a substantial source of long-term investment capital. In 1984, pension fund assets were more than $1 trillion, and fund reserves were nearly as large as U.S. corporate equities and were nearly seven eighths the size of all time and savings deposits. State and local pension funds invest a higher percentage of assets in real estate than private funds.

Pension funds are governed by the Employee Retirement Income Security Act (ERISA) which has two requirements. First, investment according to "prudent man" rules apply. These criteria require investment managers to manage the fund rationally to seek optimum risk to return balance through diversification. The fund manager needs quantifiable measures for real estate investments to calculate risk and return. These measures are difficult to obtain because there are no national market quotes for real estate as there are for stocks and bonds. Second, investment actions taken must be for the benefit

Table 5. Retail Property Lenders and Lending Criteria

Financial Intermediary	Type of Lending	Lending Limits: Total Real Estate	Lending Limits: Single Property or to Single Borrower	Loan-to-Value Ratio	Loan Term	Debt Coverage Ratio	Characteristics
Life Insurance Company (Texas LICs)	First mortgage, Leasehold, Participation, Miniperm, Arm	Mortgage assets may be up to 50% of company assets	Maximum of 10% of assets to one borrower and 5% of assets in a single loan; average loan size more than $2 million, period 1/84-12/85; American Council of Life Insurance indicated 20 major LICs financed less than 2% of retail property loans originated with loan amounts under $1 million; for period 1/86-3/87 financed less than 9.6% of retail loans with loan amount less than $2 million.	Maximum 75% interest only maximum 66.67%; amortizing loan at least an amount sufficient to pay all interest for first five years and pay off loan completely within the next 25 years; reported average L/V ratio 68.7% (ACLI)	Usually limited to 30 years; 9.5 years average loan maturity (ACLI)	Minimum 1.17 average ratio 1.25 (ACLI)	Originated through branch offices and through correspondence relationships with mortgage bankers; LICs prefer participation in current income or in ownership; ACLI reported 15% of loans were participation
Commercial Banks (CBs)	First mortgage, Leasehold, Participation, Miniperm, ARM	Total real estate loans for national banks may not exceed bank's unimpaired capital stock (stock not pledged as collateral) and surplus not needed for reserves or the amount of time and savings deposits, whichever is greater	Maximum of 10% of real estate loans limit in one loan; maximum of 10% of bank's unimpaired capital stock and surplus to one borrower	Maximum of 75% on unimproved real estate	Up to 30 years	Average 1.20	Generally do not provide long-term lending; provide lines of credit for mortgage bankers
Savings and Loan Associations (S&Ls)	First mortgage, Junior lien if hold first lien, Leasehold, Participation, ARM, Miniperm	Amount of improved property commercial loans up to 40% of aggregate amount of real estate loan investments	Up to 10% of withdrawable accounts or the association's net worth, whichever is less; single loans up to $200,000	Amortizing 30-year loans up to 90%; commercial real estate up to 90%; UIL 1984 survey reported average L/V ratio 80%	Up to 30 years	Average 1.12	Federal tax law and lending limits encourage residential lending; tend to be local lenders who are easy to approach
Mortgage Bankers (MBs)	First mortgage, Second mortgage, Leasehold, Miniperm, ARM	Varies with limitations set by correspondent institution	Varies with limitations set by correspondent institution	Varies with requirements of correspondent institution; generally between 70%and 80%	Usually 5 to 15 years; none longer than 30 years amortization	Most 1.25; leasehold with lease term no less than 20 years to national tenant 1.1; average was 1.16 (ULI 1984)	Faciliates loans; limits of lending territory, type of loan, loan amount, L/V ratio and loan term are established by loan purchaser through correspondence relationship; relationship with LICs mostly for straight term mortgages (no participation); minimum loan size (small LICs) $500,000; maximum loan (large LICs) $4 million; L/V generally 75%

Table 5. Retail Property Lenders and Lending Criteria *(continued)*

Financial Intermediary	Type of Lending	Lending Limits: Total Real Estate	Lending Limits: Single Property or to Single Borrower	Loan-to-Value Ratio	Loan Term	Debt Coverage Ratio	Characteristics
Real Estate Investment Trusts (REITS)	First mortgage	Not applicable	Not applicable	ULI 1984 survey reported average 77%	Usually 7 to 15 years; 30-year amortization	Average 1.19 (ULI 1984)	Loan originates directly and through commercial bank correspondents
Pension Funds	First mortgage, Participation	Not applicable	Not applicable	ULI 1984 survey reported average 70%	9-year term and 31-year amorization schedule (ULI—1984)	Average 1.23 (ULI 1984)	Mortgage originations through CB trust departments and LICs

Source: ***Income Property Lending***, The Institute of Financial Education, Chicago, IL., 1983, pp. 7-26; Urban Land Institute, ***Dollars and Percent of Development Finance 2Q—4Q84***, Washington, D.C., 1985; Real Estate Center at Texas A&M University, telephone survey of 22 large Texas financial institutions (five CBs, nine S&Ls and eight MBs), 1986.

of the pension plan participants. Pension fund investment in real estate is deterred by two additional factors. Real estate assets are management intensive, and they have limited liquidity.

Because pension fund managers generally lack expertise in real estate, they place a portion of their assets in bank trust departments, trust companies and life insurance companies. These fund assets are placed in pools of comingled funds for investment in real estate equities and mortgages by the managing agent firm.

Texas Life, Health and Accident Insurance Companies

The real estate lending authority of life, health and casualty insurance companies chartered in Texas is defined in Sections 2.08, 2.10, 3.33 and 3.39, Texas Insurance Code. In general, insurance companies may make first lien real estate and leasehold loans with the real estate or leasehold interest as collateral. The maximum L/V ratio for loans on commercial real estate interests is 75 percent. The leasehold loan term cannot exceed four fifths of the lease term and the unexpired lease term must extend at least ten years beyond the loan term. The borrowed funds on a leasehold loan must be repaid in equal periodic payments for a term no longer than the loan term. The maximum aggregate lending to one borrower cannot exceed 10 percent of the firm's assets and a single loan cannot be larger than 5 percent of the firm's assets.

Borrowers interested in loans from insurance companies can contact mortgage bankers who have correspondence arrangements. Member mortgage bankers are listed in ***MBA Membership Directory*** available from the Mortgage Bankers Association of America, 1125 15th Street N.W., Washington, D.C. 20005. Telephone 202-861-6500.

Credit Unions

Credit unions are not an important source of debt capital, although first mortgage loans may be obtained. (In Texas, such loans must be insured by private mortgage insurance.) Currently there is only one commercial mortgage guaranty insurance company offering to underwrite mortgage insurance on commercial real estate loans in the United States: United Guaranty Commercial Insurance Company, Box 21945, Greensboro, North Carolina 27420. Telephone 919-373-0232 or 1-800-334-9866.

Government Agencies

Both the Small Business Administration and the Farm Credit Administration can make loans on retail property. However, limitations are stringent and change with government policies and budgets. These agencies are not important sources of debt capital. Interested individuals may contact the Small Business Administration Regional Office, 1720 Regal Row, Dallas, Texas 75235. Telephone 214-767-7643. The Farm Credit Administration is located at 490 L'Enfant Plaza East S.W., Washington, D.C. 20578. Telephone 202-755-2130.

Other Lender Sources

Two references may help identify lenders. ***The National Directory of Real Estate Financing Sources*** by Larry L. Sandifar (Prentice-Hall, Inc., 1984) provides the name, address and telephone number of lenders categorized by their lending territory. The 1984 edition is the latest available. Crittenden Publishing, Inc., (P.O. Box 1150, Novato, California 94948, telephone 415-883-8771 or 1-800-421-3483) publishes two periodic references of mortgage lenders: the ***Mortgage Directory*** and the ***Small Mortgage Deals Directory***. The directories contain the name, address, telephone number and partial lending criteria for hundreds of lenders. Crittenden also publishes a periodic loose-leaf ***Dealmakers Handbook*** of commercial property lending sources and criteria and a companion weekly rate sheet.

Loan Application Procedure

An acceptable loan application usually requires the prospective borrower to submit documents verifying the borrower's creditworthiness, establishing property ownership and indicating the earning capacity and risk of the property to be financed. The content is standard, although lenders may require information to be submitted on their forms. Because applying for a loan requires significant time and expense, familiarity with the process may help the borrower avoid costly pitfalls.

Loan Submission

The loan submission package describes the property's physical characteristics and current and future income-producing capacity. The prospective borrower's financial position is included. When the information is verified, it becomes the basis for the lender's loan commitment or rejection decision (see p. 14).

The information is organized into four categories: loan application, legal documentation, property description and economic profile. Detailed characteristics of both land and improvements are included in the property description. An outline of important information which may be required is presented on pages 14 and 15. The list is not inclusive but represents information that may be required in a lender's loan submission package.

Some information may require documentation by a qualified third party for a fee such as real estate appraisers, title search attorneys, architect or engineer inspections and real estate consultant analyses. A number of items in the loan application are negotiable and will be discussed under Loan Underwriting.

Former property uses may become the borrower's responsibility. A particularly onerous trap involves toxic material sites. Many such sites have been located in Texas, and there are undoubtedly others. Court decisions have held the property owner, and even the mortgagee of foreclosed properties, responsible for clean-up costs and financial restitution to subsequently injured parties, even though the owner was unaware of the toxic material when purchasing the property. Purchasers should research carefully the use history of the property. (See Real Estate Center publication 447, ***Liability of Landowners and Real Estate Brokers in Environmental Tort Actions: Going Beyond Property Lines***.) Recent Texas law requires deed recording of a toxic material site on a property, but there is no requirement for public notice on adjacent properties. Consequently, it may be important to know if the property being purchased is adjacent to a toxic site.

Information about the location of discovered and recorded toxic materials sites may be obtained from Site Assessment Section, Hazardous Waste Management Division, Environmental Protection Agency, Region Six, 1201 Elm Street, Dallas, Texas 75270, telephone 214-767-9700 and Superfund Section, Texas Water Commission, P.O. Box 13087, Capital Station, Austin, Texas 78711, telephone 512-463-7785.

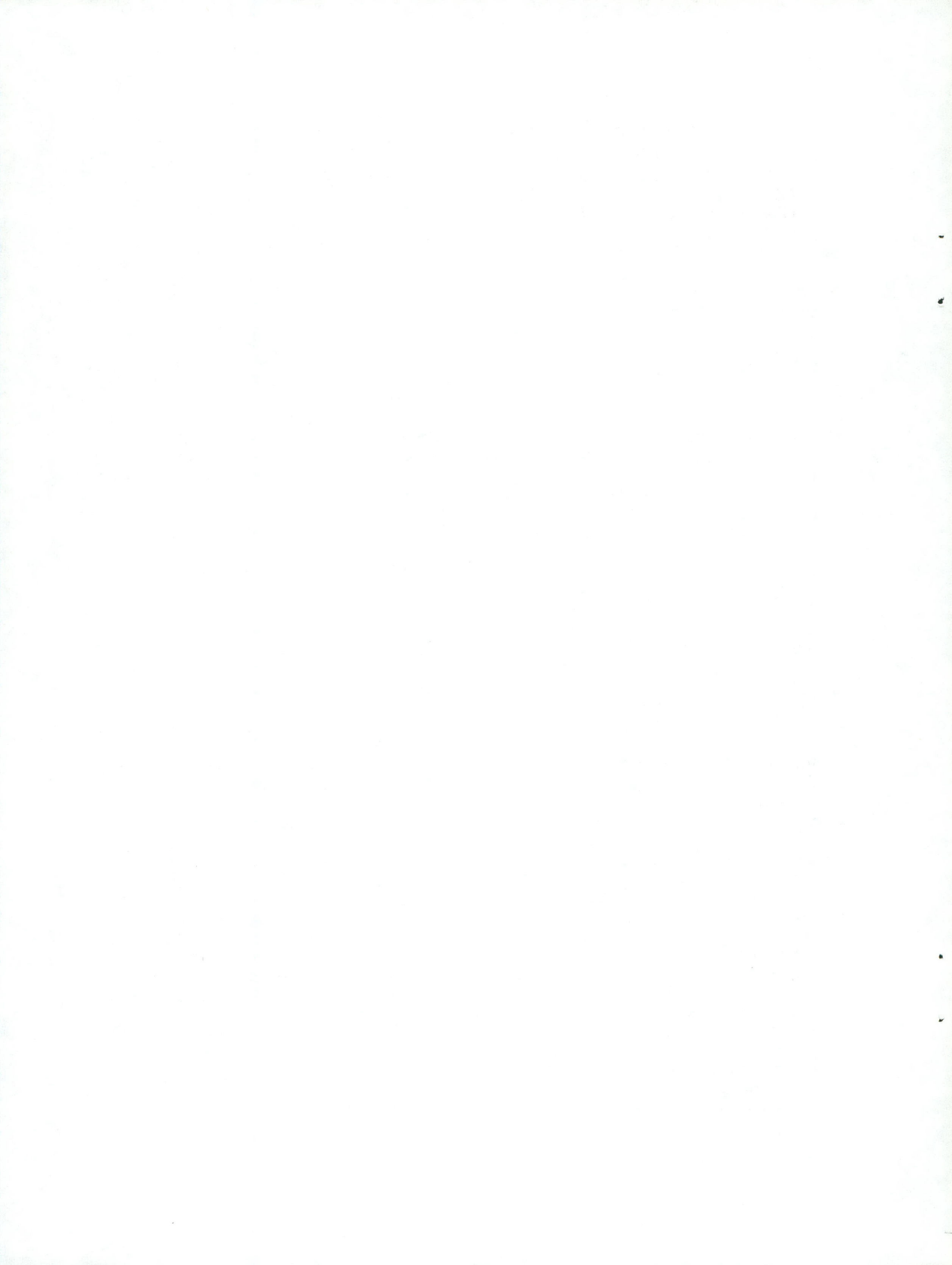
Loan Processing

The lender will verify information about the borrower's creditworthiness and the earning capacity of the property to be financed. The lender may consult attorneys and accountants. Credit reports from references and business associates are included in the submission package for evaluation during loan underwriting.

Loan Underwriting

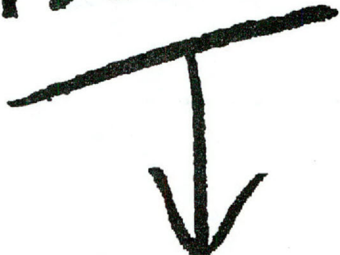
The lender first makes a loan commit or reject decision based on evaluation of the loan submission package and additional facts discovered during the lender's investigation. If the financing proposal is accepted tentatively, contract terms compatible with lender policy and assessment of loan risk and required yield are proposed to the borrower. At this point, negotiation of loan terms begins.

A borrower's strategy to reduce periodic loan payment and carrying costs and to delay interest payments and repayment of the loan must be weighed against future costs. For example, the lender may offer



YOUR

OPINION



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1. Please evaluate each characteristic of this publication: (check all applicable blanks)

	Excellent	Good	Fair	Poor	No Opinion
overall content	______	______	______	______	______
amount of detail	______	______	______	______	______
technical clarity (readability)	______	______	______	______	______
organization of material	______	______	______	______	______

2. To what degree did this publication meet your needs? (circle the number that best indicates your opinion)

very useful 5 4 3 2 1 not useful at all

3. How did you learn of this publication?______________________________

4. What magazines or periodicals do you read most regularly to stay abreast of real estate topics?

a) ______________________ b) ______________________

c) ______________________ d) ______________________

5. What other topics or information would you like to know about?

____

____

6. What is your principal occupation?______________________________

7. What real estate license do you hold? _____ broker _____ salesperson _____ none

COMMENTS:______________________________________

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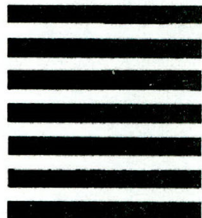

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Loan Submission Package

Loan Application

Borrower identification
Interest rate requested
Loan term requested (years)
- Straight term or adjustable rate
- Amortization period

Commitment term and expiration date (if applicable)
Income participation
Prepayment terms (or prepayment privilege)
Escrow requirements prior to closing
Loan security
- Real property (recourse to borrower by lender)
- Security documentation
- Title insurance (binder or policy offered)
- Property and casualty insurance (binder or policy offered)
- Flood insurance (if applicable, binder or policy offered)
- Mortgage insurance (may be available from United Guaranty Commercial Insurance Company, Box 21945, Greensboro, North Carolina 27420, telephone 919-373-8966 or 1-800-334-8966

Loan requirements
- If leasing land under improvements, will fee be pledged?
- Assignment of deed of trust
- Assignment of leases
- Recording of leases
- Assignment of rents
- Loss payable clause on hazard insurance
- Certification of paid real estate taxes

Borrower to purchase property on (date) for (cost)
Fees and closing costs
Present encumbrance on property
- Holder
- Original loan amount
- Present balance
- Interest rate
- Maturity

Additional financing needs anticipated in connection with this loan
Appraisal report *
- Land market value per square foot
- Building market value per gross square foot of building area
- Gross income
- Expenses paid by owner/borrower (percent of gross)
- Net operating income
- Debt service (annual)
- Cash flow
- Break even point occupancy level
- Debt coverage ratio

Borrower information
- Financial statement (may include income tax returns)
- Net worth
- Business history and experience
- Credit report

Legal Documentation

Legal description
Title opinion (if title insurance not provided) *
Survey data (plot plan of site) *
- Topographical or contour maps
- Aerial maps, photographs
- Flood plain information (U.S. Army Corps of Engineers survey—Federal Emergency Management Agency flood plain maps)
- Property dimensions
- Easements (joint driveways, etc.)
- Deed restrictions

Assessments (total unmatured, payment amount and date due)
Property taxes
Zoning
Land use restrictions
Relevant building codes
Environmental controls
- Potential hazards
- Toxic material site liability
- Environmental impact studies *

History of recorded ownership *
- Owner and inclusive dates
- Use(s) during each period of ownership

Property Description *

Land improvements
- Utilities
  - Water
  - Gas
  - Electricity
  - Waste water
  - Telephone
- Other
  - Storm water and drainage
  - Curb
  - Gutter
  - Sidewalks
  - Paved street
- Additional improvements planned to be placed on land
- Police protection, municipal or other
- Fire protection rate

Improvements description
- Year built
- Number of original buildings, number of floors in each
- Additional space added
- Names of architect, engineer and contractor
- Architectural style and type of construction (suggest use common descriptors such as those in Marshall and Swift, ***Marshall Valuation Service***)

Loan Submission Package *(continued)*

- Property manager, leasing responsibility
- Gross building area (GBA)
- Net rentable area (NRA)
- Building efficiency = NRA/GBA
- Land coverage ratio = (ground floor building area)/(land area)
- Paved area
- Width of driveways
- Parking spaces
  - Stall dimensions
  - Type and direction of parking (parallel, vertical, diagonal, other)
- Parking ratio (number of spaces per 1000 square feet NRA)
- Truck service doors
  - Number
  - Ground level
  - Enclosed
  - Truck length accommodated

Construction details and condition
- Floor plan and elevations
- Superstructure
  - Steel frame
  - Reinforced concrete
    - Precast
    - Poured in place
  - Fire protection or unprotected
- Walls
  - Material used
  - Load bearing
    - Masonry
    - Tilt up
  - Wood frame
    - Heavy timber
    - Laminated beams
  - Pre-engineered metal clad
- Roof
  - Type
  - Construction
  - Finish
  - Guarantee
- Interior construction
  - Basement
    - Material used
    - Finish
  - Floor and ceiling
    - Structural
    - Finish
  - Partitions
    - Structural
    - Finish
    - Decoration
  - Insulation and sound control
    - Walls
    - Floor, ceiling
- Equipment
  - Sprinklers
    - Wet
    - Dry
  - Appliances installed; description, number and make
- Heating, ventilation and air-conditioning (HVAC)
  - Heating manufacturer
    - System type
    - Fuel
    - Capacity (BTUs)
    - Age
  - Air-conditioning manufacturer
    - System type
      - Central
      - Individual
    - Capacity (tonnage)
    - Percent of building air-conditioned
    - Square feet per ton
    - Age
- Landscaping

Other amenities and special physical features

Economic Profile

- Economic studies *
- Market analysis-site analysis *
- Feasibility studies *
- Vacancy survey
- Community economic base, current and projected
- Gross income
  - Each tenant
    - Lease terms
    - Square feet
    - Rent per square foot
    - Minimum annual rent
    - Percentage rents
    - Common area maintenance
    - Renewal options
- Owner services provided tenants included in rent (owner cost)
  - Water
  - Heat
  - Air-conditioning
  - Electricity
  - Gas
  - Janitorial
  - Other
- Taxes paid by owner
  - Real property
  - Personal property
- Common area maintenance (in excess of tenant fees)
- Building maintenance
- Trash removal
- Administrative, police, advertising
- Repair and replacement reserve
- Operating statement

* Documentation by a third party for a fee

the borrower favorable payment terms in exchange for an adjustable interest rate with negative amortization potential or the lender may request to receive a percentage of the property sales price on or before a specified property liquidation date.

Negotiation

Elements that may be negotiable include interest rate, loan amount, interest rate adjustment frequency and index, interest rate adjustment caps both on each occurrence and during the life of the loan, loan term, periodic amortization amount and term (the loan may include interest-only payments for a specified period and a balloon payment), refinancing options, loan prepayment options, property insurance coverage, borrower's personal liability on the loan and assignment of certain property rights to the lender as security on the note. Negotiations may be aided by understanding borrower and lender motivations (Table 6).

The borrower should understand the lender's goals. The lender, particularly a financial institution, may have inflexible requirements set by competition, regulatory agencies and its own lending policies. In many mortgages, the lender may insist on language requiring lender's consent prior to any actions that might prejudice the value of the loan collateral. In most instances, the lender will agree not to withhold consent unreasonably. In practice, the concept of reasonableness has been effective in protecting each party's interests equally. An intimate knowledge of the lender's industry and an understanding of lending criteria may improve the borrower's negotiating position.

The borrower may prefer:

- a low interest rate
- a high L/V ratio
- infrequent interest rate adjustments
- low interest rate caps
- a stable interest rate adjustment index
- an option to prepay the loan at any time without penalty
- to provide insurance binders at closing validating coverage
- to limit the scope of property rights assignment to the mortgage trustee and
- no personal liability

Borrower objectives regarding loan term, periodic amortization amount and term (including interest-only payments and a balloon payment) should be based on an evaluation of periodic cash flow and expected yield on the investment under a range of financing options. A quick method for narrowing the financing options to be examined in detail uses the following basic formula.

$$NOI/DCR = DS$$
$$(DS/MC) * 100 = Loan\ Amount$$

where
NOI = net operating income
DCR = debt coverage ratio
DS = annual debt service payment
MC = annual mortgage constant

Table 6. Borrower and Lender Motivation in Financial Transactions

Borrower Motivation	Lender Motivation
Maximize	Maximize
investment rate of return	loan rate of return
periodic cash flow	asset portfolio diversification
tax benefits	
loan amount	
Minimize	Minimize
cash investment	periodic loan amortization
loan liability	lending risk

The borrower may prefer a loan without personal liability, referred to as a nonrecourse loan. Such a loan means the financed property is the security on the note and the lender may not seek a personal judgment against the borrower for any deficiencies remaining after sale of the mortgaged property. Even on recourse loans, the mortgage should contain language that releases the borrower from personal liability after amortization reduces the L/V ratio to a specified level, such as 75 percent. At that point, the property as collateral is assumed to be sufficient to protect the lender in the event of foreclosure.

The insurance coverage should depend on the borrower's sensitivity to risk and available cash to cover deductible or self-insured risks. The borrower generally chooses the insurance carrier. State Board of Insurance approved commercial property casualty policies are in two classes: the Texas standard policy limited to fire and other property casualty coverage with options for extended coverage and the Texas commercial multiperil policy that provides property casualty and liability coverage. The lender's property insurance requirement is usually only for property casualty losses that might impair the improvements as loan security. Any additional insurance is a borrower's option. The borrower may carry rent loss insurance to maintain income if a casualty reduces tenant rental payments.

The borrower should be aware that insurance loss payments are paid to the lender. Unless a clause in the mortgage note states otherwise, the lender has the option of using the funds to rebuild the loan collateral or retaining them to pay off the remaining loan balance. A borrower with considerable time and money invested in the property may desire such casualty loss payments to be dedicated to rebuilding the property which can be done by requesting such a statement in the loan documents.

In the event of condemnation, the borrower may prefer a mortgage clause that equitably divides the award between borrower and lender according to the economic impact on each party. If the property is completely taken, the lender's security is gone, and the award should liquidate the loan unpaid balance without penalty to the borrower. Should a partial taking occur, a method should be defined for determining the extent to which the economic potential of the income property is impaired and the amount by which the unpaid balance should be reduced to achieve a specified L/V ratio without penalizing the borrower. This should be negotiated.

The mortgage should state specifically the terms applying in case of default—whether or not the lender will give written notice and how long the borrower has to correct the deficiency prior to acceleration of the debt. Lenders generally would prefer no notice and latitude to use their discretion in accelerating the debt and foreclosure.

The lender may require an escrow account for real estate taxes and insurance premiums. The borrower may prefer to pay directly to the tax collector and insurance company and may want to pay prior to the end of borrower's tax year for income tax purposes.

Loan Closing

In addition to ascertaining that all documents are in order, the lender's closing agent ensures that all contractors and suppliers with claims on the property rights being transferred are paid off and that no intervening liens have been filed. During closing, the mortgage, note and all other required documents are signed, fees collected, funds disbursed to settle all accounts, and the mortgage and other assigned property rights are recorded.

Income property loans are complex and most embody unique arrangements. Usually all parties to the property transfer and financing retain legal counsel and all negotiable items are approved before the closing to save time and expense. An attorney knowledgeable in real estate law is the borrower's advisor. However, the bor-

rower should never release the authority for any legal act to the legal counsel.

Funds and agreements critical to continued work and expense before the closing may be placed in escrow at the seller's, borrower's or lender's insistence. For example, an earnest money fee or deposit may be required by the lender to proceed from loan application to closing. A subordination agreement with a third-party landowner in an improvement purchase with an underlying ground lease is required to permit the financing mortgage to become senior to the lessor's interest. The agreement may be held in escrow to be in effect simultaneously with the financing mortgage at closing. A lender may want rents to be assigned as security for periodic mortgage payments. Assignment of rents is an agreement pledging rental payments to the lender if the borrower defaults. These assignments also may be considered escrow items. The borrower's legal counsel should be able to provide competent advice about additional items for placement in escrow.

In Texas, lenders prefer a deed of trust rather than a mortgage document because foreclosure procedures with a defaulted deed of trust are usually simpler and speedier. A deed of trust conveys a security interest in the property to the lender. The borrower remains the owner and the trustee acquires the power of sale for the lender in case of default. The lender chooses the trustee and reserves the right to substitute trustees if a trustee dies or is dismissed.

There are several important clauses affecting the borrower's interest that usually are included in the loan agreement: the acceleration clause, insurance clauses, prepayment privileges, defeasance clause, alienation clause and escalator clause.

The acceleration clause permits the lender to declare the full amount of the obligation due and payable immediately upon loan default. This clause aids the lender by allowing foreclosure on the entire loan rather than on each payment as it becomes delinquent. This is a standard clause in most loan agreements and usually is not negotiable.

Most mortgages contain insurance clauses specifying requirements for insurance as protection of the collateral. Hazard insurance is always required. The borrower may have some latitude in negotiating the level of hazard coverage and deductible amounts as stated on p. 17.

The lender might prefer to include a prepayment penalty clause that provides for a penalty if the borrower repays the debt in full before a specified date. This is a negotiable clause. The borrower may prefer to be able to repay the debt in full at any time without penalty.

The defeasance clause provides that when the debt has been paid in full, the lender is required to execute a release or satisfaction of the mortgage. This document transfers the lender's interest in the property to the borrower as specified in the mortgage. Recording this release provides a public notice that the borrower has repaid the debt, that the mortgage has been released and that all property rights mortgaged have been returned to the borrower-owner.

The alienation or due-on-sale clause provides that upon sale of the property by the borrower, unless the lender approved the assumption, the lender has the choice either of declaring the entire debt to be due and immediately payable or of permitting the buyer to assume the loan. Lenders insist on this clause to provide them with an opportunity to screen and approve borrowers who may be assuming liability on a note. Furthermore, the lender's usual condition of the assumption is an increase in the rate of interest if it is significantly below the current rate. The borrower prefers no alienation clause so that the option of an assumable loan would be available with favorable terms.

An equity participation in gross rents may be a clause desired by the lender to hedge the effect of inflation on the loan yield. This clause schedules a percentage participation in gross rents above base gross rents. The participation is treated as

additional periodic interest payment required on the loan. It is not related to interest rate adjustments associated with ARMs. This clause is negotiable and is not designed to give the borrower a rate reduction in the event interest rates decline.

The mortgage includes a series of affirmative covenants on the part of the borrower requiring the property to be well maintained, taxes to be paid, insurance to be kept in force and the owner to comply with applicable laws and regulations. This avoids any claim on the pledged property rights or deterioration of the loan collateral. Covenants also may restrict transfer of title ownership. A breach of any covenant can lead to default, acceleration and foreclosure. Lenders may not become aware of problems with the loan collateral (and technically a non-monetary default) until there is a monetary default. However, when only non-monetary defaults are involved, the borrower may have difficulty curing defaults in even 60 days. Lenders recognize the problem and often are willing to delay legal action if the borrower is diligently trying to cure the default.

The borrower-buyer should receive the following documents at closing.

Warranty regarding existence of outstanding building and fire inspection orders, health department orders, condemnation for public construction or other contingencies

Escrow agreements

Real estate tax receipts and current status statement

Local tax assessor's notice of assessed valuation

Current property survey

Copies of deed restrictions, easements and water or mineral rights agreements verified as current

Title evidence up to date and title defects discovered cleared

Waivers of mechanic's liens and verifying affidavits

Escrow agreement regarding tenant or seller occupancy or title defects

Utility bill receipts for most recent period and statement of current status of accounts

Existing financing loan statement

Warranty deed or other deed offered

Deed of trust (for third-party financing)

Subordination agreement(s)

Mortgage and note (if seller acquiring second mortgage)

Existing mortgage assumption agreement

Copies and schedules of all leases

Assignment of rents (if applicable)

Insurance coverage binders or policies

Glossary

Glossary

The following definitions are based on the B. F. Saul Mortgage Company's ***A Dictionary of Mortgage and Real Estate Terms*** and Barron's ***Real Estate Handbook*** by Jack C. Harris and Jack P. Friedman.

Adjustable Rate Mortgage (ARM): A general term for any mortgage in which the interest rate, and generally the payment amount, changes periodically during the life of the loan. The interest rate periodical adjustments are made to match the rise and fall of a preselected interest rate index. Different types of ARMs have different frequencies for these adjustments. ARMs may have limits (caps) on payment amount or interest rate changes permitted for each adjustment and the maximum interest rate change (a cap) for the life of the loan.

Adjustment interval: This applies to ARMs. It is the specified time between adjustments of the ARM interest rate. Adjustment intervals currently used are three months, six months, one year, three years and five years. The Real Estate Center at Texas A&M University telephone survey of 22 large Texas financial institutions indicated that one- and five-year adjustment intervals were most common.

Amortization: A plan for gradually repaying the amount of money borrowed in periodic payments.

Amortization schedule: A table indicating the scheduled amount of each loan payment for each period during the amortization term, including the amount of principal and interest in each payment and the outstanding balance of the loan.

Amortization term: The period over which the loan principal amount is repaid. The scheduled payment amounts are determined by the type of loan. The amortization term, contract interest rate and frequency of periodic payment of principal and interest determine the amount of each payment.

Assumption fee: A fee charged by the lender when a buyer purchases mortgaged property and accepts liability for the debt that continues to exist. The fee reimburses the lender for administrative cost incurred in transferring the loan from the seller to the buyer. The fee may also include points or an interest rate adjustment to adjust the loan effective interest rate to reflect closely the market rate.

Balloon mortgage: This is a mortgage in which periodic payments are too small to pay off the loan before it is due. When the remaining balance of the loan is due, it is paid in a lump sum called a balloon payment that is usually much larger than the preceding periodic payments. The amount of each periodic payment is determined by the amortization term, interest rate and the frequency of periodic payment. This type of loan is often structured with interest-only payments during the first years.

Bullet loan: A balloon mortgage often with provisions that permit refinancing. Unlike balloon mortgages, bullet loans usually are structured like ARMs, using the prime interest rate as the interest rate index.

Contract term: The time period between the loan closing date and the date when all outstanding balances are due and must be paid to retire the loan contract.

Call provision: A clause giving the lender the right to demand repayment sooner than originally agreed upon under certain specified conditions. For instance, the call provision may allow the lender to collect the outstanding loan balance after a certain time or if the borrower sells or transfers the property or violates other default provisions.

Cap: A term used with ARMs. Caps limit the increase or decrease permitted in the adjustment of the mortgage interest rate or monthly payment from one adjustment period to the next. Also a cap may be applied to limit the mortgage interest rate change over the entire loan term. For example, caps of 5 percent (life) and 2 percent (period) permit a maximum 2 percent interest rate adjustment at the end of each adjustment period, but the total in-

crease or decrease is limited to 5 percent above or below the original contract interest rate for the loan term.

Closing: The final step in the sales transaction when title and ownership are transferred from the seller to the buyer. During closing, the general warranty deed, deed of trust (generally the mortgage form in Texas) and a promissory note (or lien note) are signed. Closing also may be referred to as *settlement* because all exchanges of money and other valuables in payment to all contract parties—including agents, attorneys and lenders—are af- fected to settle all accounts simultaneously. Other specialized deeds may be substituted or included in the transaction to define property rights transferred clearly. The warranty deed is signed by the seller transferring title to the buyer. The deed of trust (mortgage) and promissory note are signed by the buyer obligating repayment of the loan and pledging the property purchased as collateral on the loan.

Closing costs: Costs in addition to the property purchase price that are due at closing. Costs normally include mortgage origination fees, discount points, attorney's fees, agent's fees, abstract or title insurance costs, surveys, recording documents, prepayment of real estate taxes and insurance premiums. Cost sharing is a negotiable item during property purchase negotiations.

Commitment: A written agreement in which the lender agrees to loan money if the borrower meets certain specified conditions. The lender will charge a fee for making a loan commitment that may or may not be refundable.

Covenant: A promise made in legal documents such as deeds and contracts. For example, when a covenant in a deed of trust to keep the mortgaged property insured is breached, the mortgagor (borrower) has defaulted on the mortgage and the deed of trust, and the trustee may take steps indicated in the deed of trust to protect the lender's interest that may result in borrower losing the property.

Debt coverage ratio (DCR): The number of times that the annual debt service (DS) is covered by the net operating income (NOI);

$$DCR = NOI/DS.$$

Degree of leverage: A relationship between the return to the equity position (ROE) and the return to the debt position, e.g., the return to the lender (most analysts use the mortgage constant [MC]). Positive leverage exists when ROE > MC; neutral leverage exists when ROE = MC; and negative leverage exists when ROE < MC. The degree of leverage is a dynamic concept, depends on the amount of debt used in financing and varies with assumptions regarding property performance and thus cash flow to the equity investor(s).

Due-on-sale clause: A kind of acceleration clause that allows the lender to demand payment of the outstanding loan balance if the borrower sells or transfers the property interest.

Duration: This is a mathematical concept used to determine the number of years required to recover the initial investment. For financial institutions, an asset (a loan) or a liability's (a deposit) duration is the time-weighted average (number of years) of the present value of the cash flows. Mathematically, duration (D) is

$$D = ((PVCF_1(1))/PVTCF) + ((PVCF_2(2))/PVTCF) + \dots\dots + ((PVCF_n(n))/PVTCF)$$

where

$PVCF_t$ = present cash flow in year t discounted at the current yield to maturity, not the asset or liability contract rate.

(t) = The year when cash flow is received where $t = 1,2,3 \dots n$.

PVTCF = The present value of total cash flow from the asset or liability using the current yield to maturity as the discount rate.

Ideally, institutions attempt to match the duration of assets and liabilities.

Index: A term used in ARMs. The index may be the prime rate, rates for U.S. Treasury securities or other common rates used and regularly reported nationwide. The index rate plus a discount equals the fixed rate loan market rate. The index plus margin equals the introductory rate (contract rate) in the mortgage contract. During the loan term, the current index

plus margin equals the new mortgage rate each time the mortgage interest rate is adjusted.

Introductory rate: The initial rate used in ARMs. The rate is usually below (discounted from) a market rate for fixed rate permanent loans.

Leasehold subordination: This is a legal term characterized by the lessor agreeing in a lease structure to subordinate the lessor's property rights (in this report it is the land) to a mortgage on the leasehold. The property fee interest and the property leasehold are separated. However, from the lender's viewpoint, they are not separated. In the event of lender foreclosure on the loan, the lender could obtain title to the land and improvements. From a financing standpoint, there is another important factor. When the ground lease is subordinated to the loan, in effect the landowner is joined in the mortgage for lending purposes. Technically, the lender does not deduct ground rent as a property expense. Thus, the lender values both the fee interest, the leasehold interest and the improvements in arriving at the loan amount rather than just the improvement value. Assuming leasehold subordination in the example in this report, the maximum loan amount could be $1,000,000 on the purchase of $1,200,000 of improvements (L/V of 67 percent on $1,500,000).

Level payment mortgage: The loan repayment periodic payment is constant throughout the term of the loan.

Loan balance cap: A term applied to ARMs. The cap limit increases in the amount of the loan outstanding (negative amortization) as a result of deferred interest payments. Negative amortization occurs when the payment rate is less than the interest rate. When this cap is reached the borrower will generally be prevented from deferring interest, consequently, increasing the amount of periodic payment due.

Loan origination: The act of preparing a loan contract for closing that includes administrative and legal procedures and analysis of the borrower's loan application, completing the loan underwriting and assembling borrower and lender documentation required for loan closing, which is the final act of signing legal documents binding parties to the contract.

Loan to value ratio (L/V): The relationship between the total amount of the mortgage(s) on the property and the property market value.

Margin: A term used with ARMs. It is the amount (rate) the lenders add to the index rate at the time of loan interest rate determination and adjustment. The margin should reflect the lender's administrative cost plus overhead.

Miniperm: A type of permanent financing structured with a long-term mortgage amortization schedule and a short contract term, usually between three and ten years. Contract interest rates are slightly higher than on long-term permanent financing. These mortgages usually provide for refinancing.

Mortgage constant (MC): The MC is the amount of periodic payment divided by the amount of the mortgage. The MC is generally presented as a decimal and expressed on an annual basis.

Mortgage life and disability insurance: Insurance guaranteeing repayment of the loan in event of death or incapacity of the borrower to manage the loan repayment.

Point: This is also called discount point. A one-time charge at closing used by the lender to increase the effective interest rate on the loan above the contract interest rate. One point is 1 percent of the loan amount. Liability for points is always an item negotiable between buyer and seller.

Prime rate: The interest rate that commercial banks set as their base lending rate. It is not determined in financial markets and is established separately by each bank. The most quoted rate is that used by major New York banks. The prime rate is a closely monitored indicator of interest rate trend.

Recourse loan: A loan in which the lender can hold the borrower personally liable for complying with the mortgage terms. All of the borrower's assets are effectively pledged to repay the note. The

lender can, through legal action, force the sale of any of borrower's assets to liquidate the loan including law suits and garnisheeing of wages to collect a judgment. Such a loan is particularly onerous on borrower.

Release clause: A mortgage clause granting the borrower the privilege of releasing a portion of the property from the mortgage by paying off a portion of the mortgage loan. The portion released can no longer be considered by the lender as security on the loan. This can be particularly important if the retail property purchase includes land which may be sold or developed in the future.

Risk: Risk is uncertainty or variability. It is the possibility that investment returns will be greater or less than expectations. Statistically, risk is expressed as the standard deviation of the expected return.

Subordination: Moving to a lower priority, as a lien would if it changes from a first mortgage to a second mortgage.

Wraparound mortgage: A loan in which the existing loan is retained and an additional loan, larger than the existing loan, is originated. The lender on the wraparound loan assumes the obligations to repay the existing loan.

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