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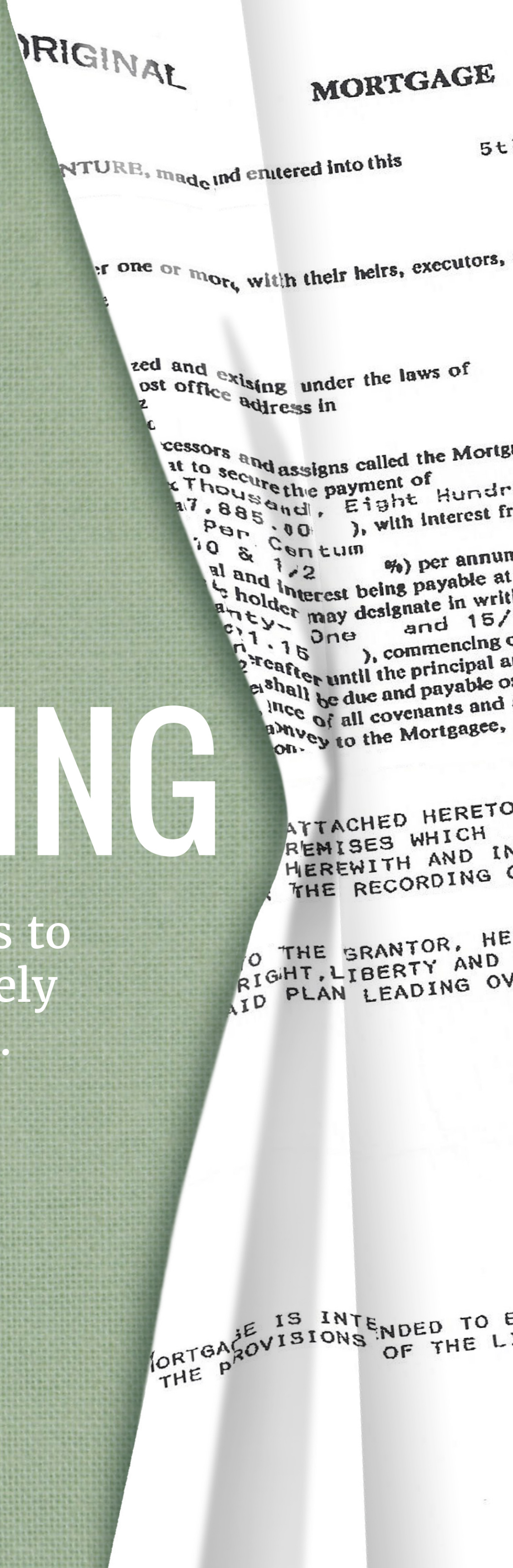
Using mortgage notes to passively and massively increase your income.



Dave Van Horn

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CHAPTER 1
How Notes Really Work

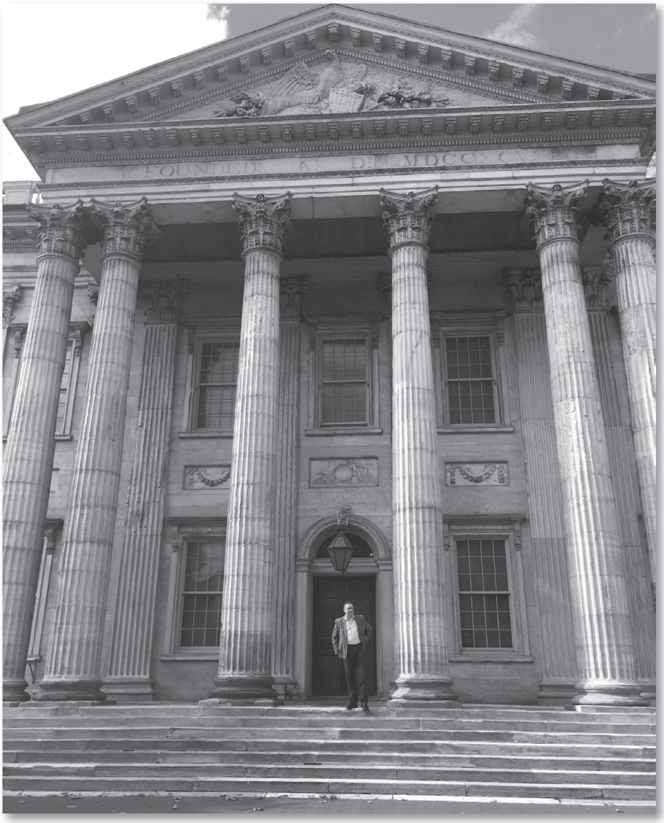
The First Note

I often get asked, "What is the note business? How come I've never heard about it before?" I thought the same thing when I first heard about it, and it wasn't until I entered the space that I realized notes have been around long before I ever came along. In fact, notes have been around for centuries. The practice of lending has been traced back to as early as 2000 BC in Babylon, with palaces and the temple acting as a lender, issuing from the wealth they had acquired. These loans typically involved issuing seed grain, with repayment from the harvest. These basic social agreements, along with an agreement on terms and interest, were documented in clay tablets.

Banks and lending have also been documented throughout ancient Greece and the Roman Empire. After the fall of the Roman Empire, it seemed lending had temporarily disappeared from the European region. But not long after, during the Tang Dynasty (AD 618–907) in China, a promissory note called flying cash, or *feiqian,* came into regular use by Chinese tea merchants. The note could be exchanged for hard currency at provincial capitals.[1] They did this to avoid carrying large amounts of money when traveling, especially since such amounts of metal coin could be heavy and cumbersome. It's been said that it was then Marco Polo who brought the idea of promissory notes

1 William N. Goetzmann and K. Geert Rouwenhorst. *The Origins of Value: The Financial Innovations That Created Modern Capital Markets* (Oxford University Press, 2005), 68.

back to Europe in the thirteenth century.[2] Modern concepts such as the issue of banknotes and fractional reserve banking developed in seventeenth-century England with Goldsmiths and eventually the formation of the Bank of England in 1695. Across the pond, the first commercial bank in America was founded in my hometown of Philadelphia in 1782. Although today's mortgage hadn't been created yet, banknotes were used, and the modern banking system as we know it took a major leap forward.



The author in front of The First Bank of the United States. Photo by Tom McCarthy. 120 South Third Street, Philadelphia, Pennsylvania. November 2, 2017.

2 Marco Polo. *The Travels of Marco Polo, a Venetian, in the Thirteenth Century: Being a Description, by That Early Traveller, of Remarkable Places and Things, in the Eastern Parts of the World* (1818), 353–355.

Just as many people don't realize they're in the note business, they also may not know that these systems and institutions have always been there, evolving with the local economies and marketplaces. Notes are around us in many facets of life. Knowing that all this history is taking place all over the world, one has to ask: Why? Why did these institutions implement these strategies? What was in it for them? What made these notes truly worthwhile? I didn't start to understand the true value of notes, and the principles behind them, until I realized how they had entered my personal history.

My First Note

Back in the late 1970s, having just graduated high school, I decided to make a pretty big decision—I was going to be the first person in my family, ever, to go to college. Being one of six kids raised by a single mother, I thought that my only road to success was through education. Upon finishing eighth grade, I took an entrance exam and was awarded a full scholarship to one of the most prestigious schools in the Philadelphia area: Archmere Academy. To give you an idea, this was the college prep school built on the estate of industrialist John J. Raskob (developer of the Empire State Building) and attended by the likes of former vice president Joe Biden. Needless to say, it opened up another world for me. Growing up poor on the outskirts of Philadelphia, I found this experience life-changing, exposing me to more than I could have ever imagined. Alongside eighty-two other students in my graduating class, I finished just before the summer of 1978. And unlike any other member in my family before me, I decided I wanted to continue my education and attend college.

Because of my grades at Archmere, I had been accepted to three very good schools in the Philadelphia area, but because of severe financial constraints, I opted for a state college less than an hour from where I lived. I enrolled as an accounting major before switching to business management about halfway through my time there. Being a college student who came from below the poverty line was tough. I wasn't even getting by on my menial food service job. I had no choice but to live on food stamps and welfare assistance. To save money, I commuted from home instead of living on campus, taking public transportation and often hitchhiking to class because I didn't have money for a car. All this work and commuting proved to be a big mistake. Paying my tuition as I went, I was working more than half the week and commuting what felt like the other half. It was way too much, and I almost flunked out. By my third year, I'd decided the only way I could continue my education while still maintaining any semblance of sanity was to get a student loan. This student loan turned out to be my very first experience in the note business.

Even though I was fortunate enough to have to obtain a loan for only the last leg of college, it was still quite a bit of money compared with my salary of $3.50/hour at the time. The terms of my loan were as follows:

Loan amount: $5,800

Monthly payment: $65.12/month

Term: Ten years

Interest rate: 6.25 percent

With a lot of hard work and some luck, I managed to finish with a business degree in five years. My student loan let me focus on my studies and live without having to constantly worry about making rent and commuting so much back and forth. I would end up being thirty-two years old when I finally made my last payment, for a total of $7,814.40. It may not sound like much, but to lend a mere $5,800, the bank made $2,014.40. And that's just for a small piece of uncollateralized debt back in the 1980s! I don't even want to show you my son's recent student loan. It makes my full loan amount look like payments for just his first year or two out of college! Now, with a mortgage, the terms and amounts are different, but the concept stays the same—except that for the bank, it may be even sweeter. With mortgage notes, the debt itself is collateralized by hard property, and generally speaking, the average mortgage is for a longer term and larger amount than a student loan. But how much money does the bank really make off a traditional mortgage? I think the simplest way to explain it is by example.

CASE STUDY
THE BEEF BAND HOUSE

Did you ever go to a “Beef and Beer” party? It may be a tradition localized to the Philadelphia area, but I hear it’s similar to a “spaghetti supper” in the Northeast or a “pig roast” in the South or Midwest. A Beef and Beer happens when someone rents a banquet hall and another person or group of people donates some kegs of beer (nothing fancy) and the beef. Specifically, thinly sliced roast beef in gravy, which is served on a kaiser roll with provolone or American cheese and maybe some horseradish. Meatballs in tomato sauce will also be found at these events, along with your common deli meat trays, macaroni salads, and coleslaw. Now, why all the food and booze? Simple. It’s a great excuse to get local communities together, often friends and families, and charge admission to raise money to donate to a person’s medical bills or a local student’s scholarship. Plus, generally speaking, working-class people in Philly love to get drunk and eat meat. You may be wondering why I’m telling you all of this, but I can assure you I have a point—a profitable one at that. One that ends in my telling you how the bank makes a killing on your loan.

I’m jumping around a bit chronologically, but to keep things simple, I’m going to choose a property from my portfolio that has a traditional mortgage. You’ll see later on how many of my properties have been obtained through creative financing, but even as an investor, I still sometimes obtain traditional mortgages. The mortgage in question was attached to a property owned by a close friend of my cousin’s. My cousin hired him to play music at his Beef and Beer events that he organized around town. Sooner or later, this guy played so many Beef and Beers, his group came to be known appropriately as The Beef Band. He was also the owner of the house I was about to buy and happened to be going through a divorce. As part of their divorce, they both agreed to sell their house. And that’s where I came in. It goes to show, you never know exactly where the best deals will come from, but they definitely lie with the motivated sellers.

The house was a three-bedroom/one-bathroom twin located fifteen minutes outside South Philadelphia (a.k.a. the hub of Beef and Beers). I purchased the home in April 2004 with a traditional residential mortgage, with the expected use of the property being a rental (so my terms were a little different from those of an owner-occupied loan). They were as follows:

Purchase price of the home: $70,000

Total amount required to obtain the property: $75,327.50, which included closing costs and a 10 percent down payment

Original loan amount: $63,000

Loan term: Thirty-year fixed mortgage

Interest rate: 6.5 percent

I always look at a purchase with two questions in mind:

- How much will I have to spend out of pocket?
- How long will it take to get my money back?

So number one, it cost me $12,327.50 out of pocket on paper. That's including the 10 percent down. I was able to obtain a seller assist for $1,500 and a commission as a Realtor of $1,250, bringing it down to only $9,577.50. The property was pretty much in move-in condition, and I was able to find a tenant pretty fast with market rent being $1,000/month at the time.

Back then, taxes were $168/month and homeowners insurance was $26.17/month. Along with my $398.20/month in principal and interest payments for the mortgage, I was all-in for a total of $592.37/month. Subtracting this amount from the monthly rent I collected, I was able to cash-flow $407.63/month. In a year, that's $4,891.56 total, which meant I would have all my out-of-pocket money back in less than two years, after which I would be making what is essentially an infinite rate of return. I've even employed a few more creative strategies to maximize my profit on this property, and I'll discuss them in further sections, but I'd like to think, with what I explained above, I did OK on my investment. But—and this is a big but—I did this transaction years before I fully understood how the bank made its money. Strictly adhering to the loan terms above, if I don't refinance or sell, I'll have made a total of $143,355 in monthly payments by the year 2034—$143,000 total for lending me a mere $63,000. That makes the interest payments a whopping total of $80,355, or a 143 percent return on the bank's money over thirty years. Now, 143 percent may sound like a lot, but it's really not much over time. Luckily, the bank thought of that, and the interest isn't even its sole driver for revenue.

How the Bank Really Makes Its Money with Your Mortgage

To understand how the modern mortgage really works, its origins and how it developed help illustrate where it is today. The word *mortgage* itself takes us through history. The etymology comes from Old French (derived in Latin). *Gage* means "pledge," and *mort* means "death."[3] So put together, a "mort-gage" is a "death pledge"! OK, maybe it's not that grim—it really referred to the death of the debt instrument when it was paid off, not the homeowner.

In the United States, it wasn't until the New Deal in 1934 that the modern mortgage, as we know it, started to form. Prior to that, mortgages in America were nearly unrecognizable compared with the ones we're all familiar with—most mortgages were for a short term (typ-

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3 Chris Weller, "11 Everyday Words That Have Weird and Disturbing Origins," *Business Insider*, published March 15, 2006, http://www.businessinsider.com/everyday-words-that-have-weird-and-disturbing-origins-2016-3/#lemur-3.

ically five to ten years) and featured “bullet” payments of principal at term. So unless borrowers could find a means to refinance these loans when they came due, they would have to pay off the outstanding loan balance. In addition, most loans carried a variable rate of interest.[4] Along with the New Deal came the establishment of the Federal Housing Authority, which enacted changes in mortgages like lower down payments, thirty-year amortization, loan-to-values (LTVs) of 80 and 90 percent or higher, and universal standards for qualifying, as well as construction standards.[5] This new set of standards not only helped grow the economy but also bumped up homeownership from 43.6 percent in 1940, the last census year before World War II, to 62.9 percent today.[6]

Conforming and Nonconforming Loans

In origination world, mortgages fall into one of two categories: conforming and nonconforming. What they “conform” to is the secondary marketplace—a market made up of large investors like insurance companies, pension funds, note funds, etc., with guidelines for the market being determined by Fannie Mae and Freddie Mac regulations. The majority of loans underwritten conform to these guidelines, and often they’ll sell the day they’re originated. In fact, I’ve even gone to closings for properties I’ve purchased where the bank has already sold my loan three or five times that day.

If it’s a loan that is nonconforming, which could happen for a variety reasons (including a problem with collateral, lack of credit, the loan amount being higher than the conforming limit, etc.), then the loan isn’t fit to sell in this marketplace. In cases like these, the bank “portfolios” the loan and keeps it in-house. This is rare with bigger banks, which is why you’ll see more community banks with residential loans in-house.

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4 Richard K. Green and Susan M. Watcher, “The American Mortgage in Historical and International Context,” *Journal of Economic Perspectives* 19, no. 4 (fall 2005): 93–114.

5 Green and Watcher, “American Mortgage,” 93–114.

6 Prashant Gopal, “Homeownership Rate in the U.S. Drops to Lowest Since 1965,” *Bloomberg*, published July 28, 2006, https://www.bloomberg.com/news/articles/2016-07-28/homeownership-rate-in-the-u-s-tumbles-to-the-lowest-since-1965.

The Flip

The loan I had on the Beef Band house was originated with Countrywide Mortgage, a large multistate banking institution. Banks this size usually originate these presumably well-underwritten loans and sell them in packages to the secondary market. These loans could sell for the same price they were originated for, or they could even be sold for above par. A bank would pay more than it's worth for future potential revenue from a loan with what they deem to be a quality borrower. So a mortgage like this at $63,000 might sell for $65,000. This quick return varies depending on the market, the quality of the borrower (and his or her credit score), and the loan itself.

Keep in mind: This small return on the flip isn't all that's going on.

Origination Fees

Although this was a Countrywide mortgage, I actually obtained the loan through a loan originator who was a friend of mine. Most loans are issued through either a mortgage broker (on behalf of banks) or a loan officer at a bank or mortgage institution. At this mortgage institution, the typical protocol is that the loan officer who issues the loan is paid a salary and receives basis points (or percentage points based on the loan amount), or he or she is entirely paid a commission of said points. The amount of points varies based on the institution/brokerage, but I've seen most of these fees start at around 1 percent of the loan amount. So in this example, the loan officer would be paid at least $630 for originating this loan. This fee is paid out only if and when the loan funds and basically pays the originator for obtaining the bank a loan.

There can also be what is known as on-the-front fees for the application or loan processing.

Servicing Rights

So the bank makes the quick return on the sale and oils the machine with origination fees, but it also makes residual fees on the servicing rights to the mortgage. Servicing rights are the rights to service an existing mortgage that are either kept or sold by the original lender to another party that specializes in the various functions of servicing mortgages. Servicing rights can include the right to collect mortgage payments monthly, set aside taxes and insurance premiums in es-