

California Real Estate Finance
Chapter 7
Junior Real Estate Finance

Chapter Purpose

It is particularly appropriate for a California finance text to have a separate chapter on junior finance. The prices on properties in many areas of the state are often higher than the allocations allowed by the underwriting guidelines of the conventional, FHA and DVA markets. As a result, owners and buyers often have to arrange for junior finance in order to complete their transactions.

This chapter examines the anatomy of a junior loan, its special clauses and the markets created for originations and sales of these relatively risky encumbrances.

Suggestions to the Instructor

Invite an investor who buys and sells junior securities to discuss the concepts of discounting and the entire primary and secondary markets of junior liens. Depending on where in California you are and in what activities your students are engaged, this may prove to be the most important lesson of the semester.

Learning Objectives

Upon completion of this chapter, the student should be able to:

1. differentiate between a senior loan and a junior loan;
2. identify the participants in the junior loan market;
3. define the risks inherent in establishing a junior loan;
4. describe the clauses that may be included in a junior loan contract to protect the lender;
5. understand that a junior loan finances the owners' equity in the property, raising payments and decreasing much of the safety cushion;
6. explain the increasing use of the home equity loan as an alternative to borrowing on personal property of credit cards;
7. define discounts and identify the participants in the secondary market for junior finance.

Presentation Outline

- I. Anatomy of a Second Mortgage/Deed of Trust
 - A. Second deed of trust is in junior position to an existing senior loan
 1. In the event of a foreclosure, proceeds from auction sale disbursed to senior lender first and then to junior lender, if any available
 2. Junior loan holder in risk position
 - B. Protective clauses
 1. Grant to the junior lien holder the right to pay taxes and insurance premiums in the event of a loan default
 - a. protects vesting of a priority tax lien
 - b. protects major loss in event of fire
 2. Grant junior lien holder the right to make payments on senior loan in the event of a default
 - a. protects problem of abandonment
 - b. possibly avoids filing of foreclosure
 3. Prohibit borrower from refinancing to the detriment of junior lien holder
 4. Secure lifting clause, which inhibits borrower from lessening junior lien holder's position
 5. Establish cross-defaulting clause, which automatically triggers a default in the junior lien if there is a default on the senior lien
 - C. Junior loan ratios
 1. Require a substantial down payment
 2. Lender incurs risk for the top portion of property value
 - D. Junior loan interest rates and usury
 1. Mostly high interest rates
 2. Often interest rate lowered to help seller dispose of property
 3. Usurious interest rates circumvented by charging points
- II. Home Equity Loans
 - A. Offered by banks, thrifts and credit unions
 1. Interest is tax deductible, unlike interest on consumer debt, which is not
 2. Proceeds can be used to purchase personal property
 - B. Attractive interest rates
 1. Often lower than market
 2. Be aware of rates that can be adjusted dramatically
 - C. Predatory lending
 1. Charging excessive interest rates and upfront fees on home loans
 2. Targets elderly and low-income borrowers
 3. Protection under the Home Ownership and Equity Protection Act of 1994

- III. Secondary Market for Junior Financing Instruments
 - A. Private companies
 - 1. Buy and sell junior loans
 - 2. Purchase price at a discount to increase yields
 - a. discount depends on terms of loan
 - b. contract interest rate vs. required
 - c. discounted over number of years until repayment
 - 3. Advertise in local papers
 - 4. California Department of Real Estate publishes booklet “Trust Deed Investments: What You Should Know”
 - B. Fannie Mae
 - 1. Second mortgage participation program
 - 2. Buys and sells junior loans from approved lenders
 - a. must be experienced junior financiers
 - b. maintain a net worth of \$250,000
 - c. maintain a reserve fund
 - d. agree to service loans sold
 - e. loans on one- to four-family homes only and must include a due-on-sale clause