Editor's Note:
This is the fourth story in a series on the high-end transaction, focused on the process of buying a luxury home—from start to finish.

Financing THE ULTIMATE HOME

A broad range of mortgage and loan options are available to buyers of luxury houses.

By Camilla McLaughlin

The digital revolution might have altered the way buyers, sellers, agents and properties connect, but the basics of the real estate transaction haven't changed a great deal, except for financing. As lenders seek to meet demands created by ever-increasing home prices, this aspect of the way homes are bought and sold continues to evolve. On the other hand, low interest rates, loans with more favorable terms and other opportunities for investment have luxury buyers looking at mortgages and other loans with new eyes.

The end result is that more million-dollar-plus buyers are opting to finance increasingly larger potions of their purchases.

Traditionally, the preferred option for high-end buyers was cash. And today, a sizable number of purchasers (about 31 percent), still pay with cash, according to a July 2003 Coldwell Banker Real Estate Corporation survey. However, even this figure is open to interpretation, since the cash that appears at the closing table is usually the result of financial maneuvers on the part of the seller.

Notes Michael Covino, whose company, Luxmac, provides customized loans for residential purchases from $1 million to more than $20 million, "The broadest definition of financing means sourcing of capital. Clearly in that definition, every buyer finances. How they do it depends on how they source that capital."

Even though these buyers might use financing in the traditional sense, more and more are seeking sources of capital that are broader than ready access to cash reserves.

"We used to say the upper-end didn't care about interest rates and financing," says Steve Chin, a Prudential agent in Park City, Utah, and a CPA. Chin believes that the low return in the financial markets is forcing more buyers to borrow funds, while low interest rates continue to woo buyers. The end result? Borrowing opportunities that are hard to ignore, especially for buyers who want to reserve their funds for other investments. At the same time, the continued appreciation of real estate in many regions means buyers continue to perceive residential properties as good investments.

"Many luxury buyers are cash flow people," observes Laura Hanson, a loan specialist with Chase Manhattan Mortgage in Scottsdale, Ariz. "They take out a loan not because they don't have the cash, but because they want to keep their money in their investment accounts, which might be making them a 20 percent return. They want to take advantage of locking in low interest rates long-term and they also want to get the tax write off."

While some financial institutions structure products to keep pace with rising home prices, overall lending follows guidelines set by the secondary markets. When the average cost of a home in Los Angeles hovers around $1 million, terms like jumbo loans, which refer to mortgages above $333,700, seem a bit of an oxymoron. Even super jumbo, which refers to loans above $650,000, seems not to have kept pace with a housing market that has supersized everything, including prices.

Although lenders report getting calls for loans in the $20 million-plus category, and financing these amounts is possible, there are only a limited number of investors willing to fund these heady amounts. Under $5 million, there are all sorts of loan combinations available from a number of sources, including private banks, lenders dedicated to the high-end market, and mortgage brokers. Compared to money-center banks, these lenders have more flexibility and continue to develop products to meet the needs of affluent borrowers.

For years, a 30-year fixed rate mortgage was the gold standard for home borrowers. Adjustable rate mortgages (ARMs) were a last resort for cash-starved borrowers trying to squeeze into that first home. Now, adjustable rate products and a shorter term are the choices of high-end buyers, most of whom are unwilling to pay the premium that the higher interest rate on a 30-year, fixed loan entails. Unlike their counterparts of the 1980s, current ARMs have rate caps that limit the amount interest rates can increase in any one year, as well as over the life of the loan. With fixed-rate periods ranging from a month to 10 years, ARMS have become an adaptable financing alternative. Rates are tied to one of three indexes: the one-year Treasury Bills, the 11th District Cost of Funds Index (COFI) and the London Interbank Offered Rate (LIBOR).

Loans linked to the LIBOR rate are especially attractive to high-end buyers, who Chin describes as "very sophisticated" and "willing to assume more risk." At press time, using the LIBOR index, payment on a $1 million loan would only be $2,396 per month. However, LIBOR loans carry significantly more risk than more traditional ARMs, since the rates are not capped. On the other hand, high-end buyers usually have greater financial resources than other borrowers and can often bail themselves out if rates go up too quickly.

Flexible documentation is another program offered by high-end lenders and is favored by affluent buyers, who are often entrepreneurs with their own businesses or are individuals whose income derives from a number of sources. Frequently, affluent buyers do not want to disclose their income, or their income might not fall into the parameters of traditional underwriters.

For instance, the Private Mortgage Banking Group (PMBG), a division of Metrocities Mortgage, offers several flexible documentation options. These options include:

1) No income/no asset, where income and assets are not disclosed on the application and are not verified. This choice is ideal for credit-worthy people who want maximum privacy.

2) Stated income/stated asset, where income and assets are stated on the application, but are not verified. This is best for those who work, but don't draw regular wages or a salary from an employer. This group of people includes self-employed individuals, or those who earn significant commissions.

3) No ratio, where income is not disclosed or verified, but assets are verified. This documentation option is perfect for affluent clients with complex finances, retirees who live off investments, and people whose finances are in transition because of a career change, recent death of a spouse, or divorce.

Currently, lenders are touting interest-only loans for all income groups, but are receiving inquiries mainly from affluent borrowers. Programs vary widely, but in general, interest-only loans allow borrowers to pay only the interest on the loan for a stipulated period of time. The advantage, says Tim Kruger, senior vice president of PMBG is, "Interest-only loans allow borrowers to qualify for a higher loan amount while maintaining monthly liquidity." Additionally, these borrowers have the option of paying the principal at any time, and often will pay a year's interest in one lump sum. This is particularly appealing to high-end borrowers with a large portion of their income in yearly bonuses. Frequently, high-net-worth individuals and their financial or legal advisors, in conjunction with the lender, will devise a hybrid loan that includes a portion that would be fixed for 15 or 30 years, and a portion of that would be interest only.

A pledged-asset product allows borrowers to promise assets like mutual funds, CDs or a stock portfolio in lieu of a down payment. Cash in the bank is usually a dollar-for-dollar pledge, while stock assets are pledged at 143 percent of what the down payment would be. The money is maintained in a custodial account. Buyers are not obligated to liquidate stocks while values are depressed, and theyare able to make trades in the account, but they have to be approved by the investor. Says Kruger, "We have been getting requests for more of these types of loans since the downturn in the stock market."

Ideal candidates for this type of product would be individuals with significant assets or those who lost equity in the market and are now recouping losses. Since assets in these accounts technically remain in the borrower's name, this is also a good loan for someone who needs to protect their net worth.

Since most loans for significant sums are configured on a case by case basis, lenders typically construct something that will meet the meets and specific tax and income situation of the buyer. Typically, buyers who want to finance 90 percent of their purchase opt for a first mortgage for 75 or 80 percent of the purchase price and then add a second mortgage, which can be a secured line of credit on the home or other assets, to close the gap with the purchase price.

Not only are more luxury buyers financing purchases using some type of a mortgage, but they are also financing a larger portion of the purchase amount. "We are getting leverage "We are getting leverage requests for very high leverage amounts," Covino says. "Now, we're seeing people wanting to get a loan for 70, 80 or 90 percent. They realize there are other investment opportunities, and what they are doing is using as much leverage on the home as they can. They don't want to utilize all their cash in purchasing a home." With interest rates at such low levels, borrowers find that their investments are earning more than the cost of the debt.

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Additionally, in markets like Manhattan, where "$3 million for a three-bedroom apartment is not extraordinary," observes Beth Divny, a broker with The Manhattan Mortgage Company, buyers whose income qualifies for a loan still might have trouble accumulating cash for a sufficient down payment. Often lenders will add a second mortgage or a second line of credit on the home or other assets to close the gap with the purchase price.

In Manhattan, the challenge for borrowers is often not fulfilling the terms established by lenders, but meeting the expectations of co-op boards. “The banks just care if you have a little bit of post-closing liquidity, and the boards want a lot more,” Divny says.

Clearly, the financial arena is particularly accommodating to luxury buyers. Now, the challenge becomes ensuring that the homes appraise for the required value. Appraisals for luxury properties are particularly vexing. Typically, there are few, if any, comparable sales, at least in the traditional interpretation of comparable as the most recent sales of the most similar property in closest geographic proximity. Many appraisers are not accustomed to valuing some of the one-of-a-kind features and locations that accompany luxury properties.

“This is an issue that we wrestle with every day,” Kruger says. “It can be a problem with exceedingly expensive homes and very unique properties.” When it comes to appraisals, like a good real estate agent, Kruger often works as an advocate of the borrower, “in a prudent fashion,” he adds. In general, he says, appraisal issues are more likely in refinancing scenarios and in less urban areas.

Clearly, the biggest change in financing for luxury buyers is the number of options available. Each circumstance is unique, so it is important for buyers to consult their own personal advisors to determine which financial option is best for their purchase.

With financing in place, buyers can now anticipate closing the transaction and actually enjoying the fruits of their purchase—providing there aren’t any last-minute glitches.