A CLOSER LOOK AT WRAPAROUND FINANCING

by Leonard V. Zumpano, Edward R. Mansfield, and Jonathan J. Davies

In the past two years, persistent inflation and the attendant instability in the capital market are once again focusing attention on the wraparound mortgage. A financially attractive alternative for both the lender and the borrower during high interest and tight credit periods, the wraparound is also an extremely versatile financing device. It can be readily tailored to satisfy many different mortgage lending objectives. However, it has some serious limitations that must be assessed in order to minimize the risks associated with its use.

Classifying Wraparound Mortgages

The wraparound mortgage is technically a subordinate mortgage which, as the name suggests, wraps around an already existing senior mortgage. The loan amount is equal to the unamortized portion of the first mortgage and any additional funds that may be advanced by the wraparound lender. The wraparound mortgagee takes over servicing the senior mortgage from debt service payments received on the wraparound. Although the basic characteristics of wraparound mortgages are familiar, their specific structure can vary significantly.

Perhaps the best way to categorize[1] the various types of wraparound mortgages currently used is by the differences in their three basic components — term, amount, and amortization schedule. The maturity of the wraparound can be shorter than, coincident with or in excess of the term of the underlying senior mortgage. The wraparound mortgage can provide additional financing or be used to reduce the debt service and/or extend the term of a prior debt obligation (i.e., a no additional funds, extended term wraparound). Amortization on the wraparound mortgage may be complete or partial and may or may not occur concurrently with the underlying debt. Alternatively, the outstanding balance of the wraparound may increase as the senior debt obligation is amortized. The latter happens when debt service on the wraparound does not cover debt service on the prior mortgage, necessitating periodic out-of-pocket cash advances by the wraparound mortgagee.

Determining the Yield

The unique character of the wraparound mortgage also accounts for the unique nature of its yield. Because the wraparound lender services the first mortgage out of payments received from debt service on the wraparound, income for the wraparound mortgagee is equal to the interest payment differential on the two loans. The effective yield on the wrap is, therefore, equal to net interest divided by the lender's investment, which is equal to the differences between the wraparound loan balance and the unamortized portion of the senior mortgage. However, the first mortgage amortizes at a different and usually faster rate than the wraparound. Therefore the effective yield changes with each debt service payment, since an increasing portion of the income earned on the wraparound is paid to the senior mortgagee as amortization.[2] Instead of being retained, this amortization payment is added to the loan balance owed on the wraparound.

Deferred interest is best thought of as a series of

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"advances" or additional "loans" made to the wraparound mortgagor to meet the senior mortgage obligation. Consequently, since these loans advanced by the wraparound lender will increase over the term of the underlying debt, the effective yield on the wraparound falls as the lender's net investment increases and the leverage factor diminishes.

Many different mathematical formulations, yield tables, computer programs, and even hand calculators can be used to calculate the effective overall yield on wraparound mortgages.[3] However, none of these methods is completely satisfactory for comparing or ranking the yields on wraparound mortgages with the return on other more traditional investments.

Wraparound yield formulations that incorporate the effects of changes in net interest and net inestment occurring over the term of the wraparound fail to account adequately for the time value of money. Since part of the interest earned each period is not retained, the wraparound lender does not have immediate use of these funds for reinvestment as with most other types of loans. Alternative procedures that estimate the realized yield on wraparound mortgages can be used to overcome the above problem, but here also, the usefulness of these discounted cash flow techniques depends upon the validity of the reinvestment assumptions underlying their construction.

Ultimately the choice of an appropriate yield index should reflect the type of alternative investments available to the lender whether or not the investor is subject to an effective capital rationing constraint. Regardless of how the yield on a wraparound mortgage is calculated, the following factors will have an impact on the actual return:

- The smaller the initial or net investment of the lender in relation to the wraparound loan balance, the greater the leverage and the higher the yield.
- For the same reason, the greater the interest rate spread between the wraparound and the underlying debt obligation, then the greater the overall yield.
- The shorter the maturity differential between the wraparound and senior mortgage, then the greater the yield. This occurs because the shorter term wraparound will generate a larger cash flow and minimize the exposed or unlevered portion of the wraparound's term. Therefore, for a given initial inestment and interest rate spread, the yield on a coincident term wraparound will always be appreciably greater than for an extended term wraparound. However, once the term of the wraparound exceeds the maturity of the underlying debt, additional term extension will result in only nominal reductions in overall yield since the wraparound is no longer levered. (See Figure for illustrations of alternative yield calculations.)

FIGURE

Rates of Return for Wraparound Mortgage when First Loan is 20 years at 10 percent

Ratio P2/P1*	Contract rate	Mean	Internal	Mean	Internal	Mean	Internal
1.0		2.2017†		1.3694†		1.1136†	
	12%	12.2651%	12.4761%	13.6727%	14.4753%	24.4034%	27.1798%
	14%	14.5249%	15.0019%	17.2325%	19.2897%	34.1380%	43.0783%
	16%	16.7806%	17.5831%	20.7097%	24.4859%	42.1230%	59.2604%
1.5		3.3026†		2.0541†		1.6703†	
	12%	12.1501%	12.2925%	12.7213%	13.1408%	14.6675%	14.8230%
	14%	14.2975%	14.6098%	15.4047%	16.3359%	18.8748%	19.4437%
	16%	16.4428%	16.9544%	18.0592%	19.5933%	22.7895%	23.9784%
2.5		5.5043†		3.4235†		2.7839†	
	12%	12.0807%	12.1652%	12.3423%	12.5524%	13.0424%	13.0807%
	14%	14.1600%	14.3425%	14.6690%	15.1170%	15.9586%	16.1029%
	16%	16.2382%	16.5328%	16.9836%	17.6974%	18.7841%	19.0924%
		5 years**		10 years**		15 years**	

* P1 is the original principal for first loan and P2 is the original principal for wraparound loan, i.e., unpaid balance on first loan plus amount advanced.

† Numbers are the ratio of P2 to unpaid balance on Loan 1 which reflects the relative funds advanced by the wraparound lender.

** Time remaining on first loan at start of 15-year wraparound.

Note: Calculations for mean rate are based upon monthly changes in lender's net interest income and net investment over the term of the wraparound mortgage; calculations for internal rate incorporate the lender's initial net investment and monthly pre-tax cash flow over the term of the wraparound mortgage.

Using Wraparound Mortgages

Acquiring Additional Funds. Possibly the most frequent and well known reason for negotiating a wraparound mortgage is to obtain additional funds when refinancing would not be financially advisable because of high prepayment penalties or a very low interest rate on existing indebtedness. With a wraparound mortgage, the borrower can procure additional financing without having to extinguish the prior mortgage and at an interest rate that is lower than prevailing rates on new first mortgages. For the same reason, a wraparound is also more attractive than more traditional and higher cost junior mortgage financing.

The obvious appeal of the wraparound mortgage for the lender, and the reason the lender can afford to offer what are effectively below market interest rates on the loan, is the financial leverage provided by the unamortized senior mortgage debt. The wraparound mortgagee is earning interest on the full amount of the wraparound loan, but only advancing the difference between the wraparound mortgage and the outstanding balance on the senior mortgage. In return for "servicing" the smaller, lower cost first mortgage, the wraparound lender can effectively lever his own return to a level well above the nominal contract rate applicable to the wraparound mortgage. In periods of tight money, this is especially advantageous since wraparound financing makes a little money go a long way and at acceptable yields.

Increasing the Income of the Borrower. A wraparound mortgage also can be used to enhance the income producing potential of a seasoned property by restructuring its debt service. By "refinancing" the existing loan balance of a partially amortized senior mortgage over an extended term (a no-additional funds, extended-term wraparound),[4] the borrower can reduce his debt service and increase the cash flow of the property. Net or after-tax cash flow will also increase, even with lower debt service payments, because the new loan will have a reduced amortization schedule, thereby providing larger tax deductions for mortgage interest.

However, in exchange for smaller debt service payments and greater tax savings, the wraparound mortgagor will face a larger future loan balance. Because debt service on the wraparound will be less than debt service on the senior obligation, the wraparound lender will be required to make periodic cash advances over the term of the underlying mortgage. The principal incentive for the wraparound mortgagee, in this situation, is the equity build up that results from the compounding of deferred interest and the out-of-pocket advances.

Procuring Blanket Financing. When acquiring or refinancing multiple properties subject to existing mortgages, a wraparound blanket mortgage can prove more advantageous than negotiating individual mortgages for each parcel or even a blanket first mortgage. If some of the properties have large equities and low interest rate mortgages, the borrower may be able to negotiate a favorable interest rate on the entire package of properties because of the leverage provided the lender by the underlying mortgage loans.

Facilitating Installment Sales Tax Treatment. A wraparound mortgage can be used to achieve installment sales tax treatment which otherwise might not be possible. Section 453 of the Internal Revenue Code allows a seller to defer capital gains from the sale of property until the proceeds are received so long as payments in the year of sale do not exceed thirty percent of the sales price.[5]

The problem often encountered in obtaining such beneficial tax treatment for real estate sales is that the regulations define payments to include the excess of an assumed or subject to mortgage (paid by purchaser) over the seller's adjusted basis in the property. Thus, if property with a low adjusted basis and large mortgage is sold using a traditional purchase money mortgage, the excess of the existing mortgage over basis may be greater than thirty percent of the sales price, thereby precluding installment sales treatment.

The use of a wraparound mortgage, however, may allow the seller to circumvent the first-year payment test. Since the parties to the wraparound do not intend for an assumption to occur, nor is it intended that the buyer take on any direct liability for the existing mortgage, the excess of the senior mortgage balance will not be considered a payment and installment sales accounting is preserved.

Although as yet there has not been a concerted attempt to preclude the use of wraparound financing as a means of achieving installment sales treatment, caution is warranted. If the wraparound lender's payments to the senior mortgage holder are dependent upon receipt of funds from the borrower, or if the wraparound mortgagor has the right to make payments directly to the senior mortgage holder, the more likely a constructive assumption will be deemed to exist and installment sales treatment will be disallowed.

Risk and Limitation Pitfalls

Although the wraparound mortgage as a subordinate lien shares some risks common to all junior mortgages which should not be ignored, its unique character also creates additional problems not usually encountered with more traditional financing arrangements. Some of the risks or difficulties associated with wraparound financing are interrelated, the type and degree varying because of differences in institutional, regulatory and tax factors.

Default Risk. As indicated earlier, the portion of the

income earned on the wraparound that is paid as amortization on the senior mortgage is added to the amount owed on the wraparound mortgage. Consequently, the wraparound lender's net investment increases over the term of the underlying loan and is only recovered at a later date when the wraparound mortgage either amortizes or is refinanced. This not only presents some cash management problems (income earned but not received) but, in the event of default, the funds "advanced" may never be recaptured if the property's value falls or does not keep pace with the growth in the lender's net investment. The risk is even greater if debt service on the wraparound does not cover debt service on the underlying mortgage. In this case, the wraparound lender will have to make actual cash advances to cover loan payments on the first mortgage and both the outstanding balance on the wraparound mortgage as well as the lender's net investment increase over the term of the senior mortgage.

Negative Cash Flow. Even if debt service on the wraparound mortgage exceeds debt service on the senior mortgage, the lender's cash flow may be negative if the income earned on the wraparound is taxable. This will occur if tax on net interest earned exceeds the pretax cash flow to the wraparound mortgagee (equal to the difference in the two loan payments). Although the principal wraparound lenders are either tax exempt institutions or lenders who can effectively minimize taxable income, ambiguity regarding both the actual nature of the wraparound mortgage and the tax to which it may be subject can create what is, in effect, a reverse tax shelter — an asset that generates a negative cash flow and positive tax liability.

If a tax-exempt wraparound lender, such as a pension fund, assumes or is contractually obligated to make debt service payments on an underlying senior mortgage, the income earned on the wraparound can be construed to be debt financed and, therefore, according to the tax codes[6] is taxable under the corporate income tax. However, an IRS ruling applicable only to REITs seems to refute this interpretation.

Revenue Ruling 75-99[7] states that payments made by a wraparound lender on the senior mortgage (from debt service payments received from the wraparound mortgagor) are made on behalf of the borrower. Therefore, the REIT is merely serving as a conduit for the collection and disbursement of funds to the senior mortgage holder. If this is the case, then by implication the wraparound mortgagee is not really obligated to pay interest on the underlying debt and the wraparound loan is not debt financed. Instead, it would appear that it is the wraparound mortgagor who is liable for the underlying debt obligation.[8] Moreover, and for the same reasons, payments made by the wraparound lender to amortize the senior mortgage should not constitute income. At the present time, although the tax status of the wraparound mortgage is still unclear, a number of pension funds are actively engaged in wraparound lending.[9]

Lien Priority. By construction, the wraparound mortgagee makes periodic "advances" to the wraparound borrower with each debt service payment on the senior mortgage. As a result, the net loan balance on the wraparound will increase over the term of the underlying debt. If, in between these periodic advances by the wraparound lender, a new lien is placed on the property, a question arises as to which lien has priority in the event of foreclosure. Unfortunately, there is no simple answer, since priority among liens is a function of several factors including prevailing state laws, the types of liens involved, and the specific provisions in the wraparound mortgage.

Because the lender has some control of the provisions of the wraparound mortgage, the latter consideration deserves additional comment. Given the results of previous litigation, the best protection for wraparound lien priority is to make debt service payments to the senior mortgage holder obligatory.[10] However, such a provision may engender adverse tax consequences for some tax-exempt lenders if as a result the IRS deems the income from the wraparound to be debt financed and taxable. A preferred alternative, therefore, might be to make debt service payments on the senior mortgage mandatory only so long as the wraparound mortgagor continues to make timely payments on the wraparound loan.

Refinancing and Prepayment. In order to protect his investment and insure a satisfactory return on the loan, the wraparound lender must be able to limit the borrower's right to refinance and prepay the underlying mortgage debt.[11]

Since the wraparound mortgage is a subordinate lien, any increase in the loan balance on the senior mortgage will reduce the equity available to support the wraparound lender's investment. Equally important, any changes in the terms of the underlying debt obligation such as an increase in the interest rate or higher monthly payments will reduce the yield on the wrap.

Prepayment presents similar problems. Since the yield on the wraparound loan is predicated on the leverage provided by the underlying mortgage, early prepayment will result in a substantial reduction in the return to the wraparound mortgagee.

A related issue is the due-on-sale clause, now commonly found in most first mortgages. Since this clause permits a mortgage lender to call in the loan in the event of any assignment of title, this provision can effectively defeat the benefits of wraparound financing. Even if the first mortgage holder does not accelerate the mortgage note on assignment of title, the price of waiver will usually be an upward adjust-

ment in the interest rate, thereby eliminating the possibility of a levered return for the wraparound mortgagee. For the same reason, if the recently authorized roll over or renegotiated rate mortgage gains wide acceptance,[12] the future applicability of wraparound financing will be severely restricted.

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NOTES

1. Sam W. Galowitz, "How to Use Wrap Around Financing," *Real Estate Law Journal*, Vol. 5 (Fall 1976), 107-137; and George H. Bigelow, "Wrap Around Mortgages: An Update," *The Mortgage Bankers* (November 1979), 17-21.

2. Richard T. Garrigan, "Wrap Around Mortgage Financing: Enhancing Lender and Investor Wealth," *Real Estate Issues* 4 (Summer 1979), 23-24; and *Yield Table for Wrap Around Mortgages* (Boston, Financial Publishing Company, 1973).

3. Ronald H. Timms, *Wraparound Mortgage Lending*, U. S. League of Savings Association, 1976; and Francis P. Gunning, "The Wraparound Mortgage — Friend or U.F.O.?", *Real Estate Review* 2 (Summer 1972), 35-48.

4. Although this type of financial arrangement usually requires term extension if the wraparound is self-liquidating, this need not be the case. A balloon note can be negotiated, requiring repayment before, with, or after the maturity of the first mortgage.

5. It should be noted that, at present, Congress is considering a bill that would amend Section 453 to eliminate the thirty percent restriction on the use of installment sales treatment.

6. I. R. C. Sections 511 and 514.

7. Revenue Ruling 75-99, 1975-1 CB 197. It should be noted that this Revenue Ruling is specifically limited to REITs that combine wraparound mortgages with nonrecourse financing.

8. At the same time, the logic of this ruling implies that a wraparound mortgage given by a seller on a property subject to an existing mortgage cannot be used to achieve installment sales treatment, since it is the buyer who effectively assumes the underlying senior mortgage debt.

9. Bigelow, op cit., 20.

10. Galowitz, op cit, 128-129.

11. Arnold Leider, "How to Wraparound a Mortgage," *Real Estate Review*, 4 (Winter 1974), 29-35, and "Wraparound Financing by a Commercial Bank," *The Journal of Commercial Bank Lending* 56 (April 1974), 2-22.

12. In April 1980, the Federal Home Loan Bank Board unanimously approved new regulations permitting federally chartered savings and loan associations to offer roll over mortgages. Interest rates on these loans can be renegotiated every three to five years, with the maximum interest rate change limited to five percentage points over the term of the mortgage. Moreover, federally chartered savings and loan associations are no longer obligated to continue to offer fixed rate mortgages as was the case under the regulations that authorized the variable rate mortgage loan.