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Investors Who Do a Few Mortgages on the Side

By DAWN WOTAPKA

Dallas attorney Joey Messina has a side business some might find surprising: He uses his own money to make mortgage loans to people who banks likely would avoid.

Across the U.S., some mom-and-pop investors are yanking money from retirement accounts and safe but stingy savings to take on the risk of becoming "hard-money" mortgage lenders. Dawn Wotapka explains.

In the past two years, Mr. Messina has funded 20 mortgages, ranging in size from $40,000 to $102,000. The mortgages carry interest rates of 14%—more than double the rates charged by most banks and far superior to the returns Mr. Messina received on his savings account. And despite the housing market's weakness, Mr. Messina believes that originating home loans in the current environment, when many economists believe housing is at or near bottom, is less risky than putting money in the volatile stock market or opaque bond market.

"I can't drive by and look at those [stocks and bonds]," says Mr. Messina, who is 35 years old. Plus, he says, investing in residential real estate earns "passive income that doesn't require much work from me."

He isn't alone. Across the nation, a number of mom-and-pop investors are pulling money out of their retirement accounts and safe, but low-yielding, savings to take on the risk of becoming "hard-money" mortgage lenders, who charge high interest rates to borrowers who have been rejected by traditional banks.

Hard-money mortgage lending represents just a tiny slice of the mortgage market, although the activity is growing rapidly. Guy D. Cecala, publisher of trade publication Inside Mortgage Finance, estimates hard-money loans will account for about 1% of the 5.5 million mortgages expected to be originated this year. But he says activity in that sector is up sharply from a few years ago, when very few hard-money loans were originated.

Brandon Thibodeaux for The Wall Street Journal

Keith Borg took a 'hard-money' loan for a home he bought in Dallas.

Some critics compare hard-money lenders to predatory subprime lenders, lightly regulated operations that cater to people desperate for money. NeighborWorks America, a nonprofit housing organization, urges consumers to ask an unbiased housing or credit counselor to study the rates and terms to make sure they aren't predatory.

But others say these private lenders fill an important void. Robert and Yvonne Fassett used a hard-money loan last year to restructure their finances after a kitchen-cabinet distribution business they owned for 30 years suffered in the downturn, ruining their credit. The couple received a one-year, $120,000 loan with a 12% interest rate secured by the equity in a vacation home in Key Largo, Fla. They used the funds to pay off the vacation home and cover mortgage payments on their primary home in Teaneck, N.J., until they could find a buyer. "They rescued me. It bought us a little escape plan," says Mr. Fassett, 59. "The fees and interest rate were no doubt higher than a bank, but it was well worth it since no bank was willing to listen."

For the most part, hard-money mortgage lenders must follow the same rules as traditional mortgage players, such as abiding by truth-in-lending rules, which require lenders to be upfront about the loan's length and cost. States also regulate the industry.

Seminars and training videos are popping up to teach would-be hard-money mortgage lenders the tricks of the trade. Leonard Rosen, a former financial news anchor, is charging between $595 and $995 for a spot at his "Pitbull Mortgage School," a one-day seminar held twice a year. The next one, scheduled for later this month in Las Vegas, has sold 286 of the 300 available seats so far, he says.

Bess Hoffman became a hard-money mortgage lender to supplement her retirement income. In the past three years, the 72-year-old has taken more than $250,000 out of money-market accounts and CDs to fund 13 loans that she says have delivered a 14% annual return, compared with 2010's 11% rise for the Dow Jones Industrial Average.

For borrowers who have been turned away by banks, hard-money can provide a chance to take advantage of opportunities in the market. Ever since mortgage defaults surged after the housing crash, banks have been reluctant to lend to certain types of borrowers, including investors.

Keith Borg, a 26-year-old Dallas accountant, has taken out two hard-money loans totaling nearly $200,000 with Longhorn III Investments LLC, a four-year-old, Dallas-based hard-money lender and brokerage. For the first loan, he borrowed $95,000 to purchase a foreclosed home that he rented out for $1,125 a month. Several months later, he refinanced into a traditional 30-year mortgage.

Other borrowers seeking hard-money loans are self-employed individuals who can't fully document their incomes and people with low credit scores, whose mortgage applications these days are routinely rejected by banks.

Judith and Allan Cunningham are a case in point. Allan lost his job as a college professor several years ago and fell behind on his credit-card payments, which lowered his credit score. But recently, the couple took out a $69,000 hard-money loan for the purchase of a $137,000 three-bedroom home in Sunrise, Fla. At 11% interest, the monthly payments are $1,100 for three years. When the loan comes due, Mr. Cunningham hopes to have a job and improved credit. "It's expensive, very expensive, but if you really want to have your own home, and your credit is not up to par, it's the only way to go," he said.

Typically, hard-money lenders are matched with borrowers through loan brokers, who make a commission on each deal. Most loans are short-term, lasting a few months or as long as several years. Some are set up with low monthly payments and a balloon payment due at the end of the loan term.

When the loan comes due, borrowers either refinance into a conventional mortgage, flip the property to pay off the loan or, if those measure fail, extend the hard-money loan. "The hard-money loan is an interim loan," says Sophie Lapointe, a co-owner of Five Star Mortgage in Las Vegas, which doesn't do hard-money loans.

Lenders say that defaults are low, in part because borrowers have plenty of equity tied up in the properties themselves.

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