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Vendor mortgage issue draws reactions

Readers fear original borrower on hook if buyer takes over loan.

A recent column on Brad and Jennifer's taking over their vendor's mortgage must have triggered some hot buttons in a number of readers, and it brought a storm of e-mail asking for more information.

The questions and comments from readers were so interesting that they merit a separate, follow-up column on the same subject.

Brad and Jennifer paid in the mid-$400,000s, some $13,000 higher than the asking price, in a multiple bid scenario. With a down payment of about $200,000, they arranged a new five-year first mortgage for $240,000 with interest at 7.25 per cent.

A few days before closing, I pointed out to them that the vendors had a $207,000 mortgage at 5.95 per cent. The vendors were paying off that mortgage, along with a $3,000 penalty for early discharge. Nobody had bothered to check that the mortgage was assumable - it did not have to be paid off but could be taken over by a new owner.

The punch line of the story was that Brad and Jennifer arranged to take over the old mortgage at 5.95 per cent instead of keeping their new mortgage at 7.25 per cent.

They came up with a larger down payment, and (this was the key to the mortgage assumption) arranged to get the vendors off the hook on their covenant to pay to the old mortgagee. They saved $10,000 in after-tax dollars ($20,000 in before-tax salary), and split the $3,000 penalty with the vendors.

Typical of the e-mails I got was one from Martina Wood, who noted, "My recollection from the early '90s, when numerous mortgages went into default, was that the original mortgagor could be held responsible for the mortgage if the person assuming it defaults at any time before it is fully paid."

Wood is correct. The lender does have the ability to go after the original borrowers for the amount of any shortfall after a mortgage default and sale.

The main exceptions to this rule are if the bank releases the original owners from their promise to pay in exchange for the purchasers' taking on the liability, or if the new owners and the bank - without the consent of the original borrowers - enter into a new or substantially different agreement (such as an extension at a new rate or a principal increase).

John Mercer, associate broker at Re/Max Realtron, asked, "How did your clients manage to get the vendors released from their obligation to pay off the mortgage in one day? I could certainly benefit from any tips you could give me in this regard."

It is important to remember that banks are in business to lend money, not take it back. They make money lending money, and are generally making much less money when a borrower pays off a mortgage, even if there is a penalty.

In Brad and Jennifer's case, they had a large enough down payment and sufficient incomes to justify the bank's decision to allow them to take over the mortgage and let the original owners off the hook.

Even if they had not been released, the vendors should have been comfortable with Brad and Jennifer's annual incomes and large down payment.

In any other situation, if the original owners are not released from their covenant, should they go ahead with the deal and accept the risk that the bank will come after them for any future shortfall?

Although each case will turn on its own particular facts, some vendors will take the risk based on the size of the down payment, the credit of the purchasers, or any difficulties they may be having in marketing the house. Other vendors would rather pay the penalty to break the mortgage and sleep at night, knowing the bank will never come after them.

Another option would be to make it worthwhile for the vendors' bank to release them from their covenant by offering the bank the mortgage on their new house, or all their personal and business banking, as an incentive.

Banks are negotiable and an unfavourable decision at a branch level can often be successfully appealed to the regional or head office.

Never take no for an answer the first or second time you ask.

Some buyers can get the advantage of a vendor's mortgage by increasing it and blending the existing rate with the new rate for the same or a longer term. This is called blend and extend or increase and blend.

In this scenario, the old mortgage is replaced by a new one and the vendors are released from their obligations.

The point of my original column was to encourage vendors and agents to routinely consider whether the existing mortgage can offer any hidden value to a purchaser.

In Brad and Jennifer's case, the house had a $10,000 added value feature that the agent and vendor missed.

Had it been considered, it could have resulted in a higher asking price and even a higher sale price.

It's like forgetting to advertise that the 1998 Buick or the two snowmobiles in the garage come with the house.

The existing mortgage had a huge value to Brad and Jennifer and it was a mistake to overlook it when marketing the house.

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