"What is a wrap-around mortgage, and who is it good for?"

A wrap-around mortgage is a loan transaction in which the lender assumes responsibility for an existing mortgage. For example, S, who has a $70,000 mortgage on his home, sells his home to B for $100,000. B pays $5,000 down and borrows $95,000 on a new mortgage. This mortgage "wraps around" the existing $70,000 mortgage because the new lender will make the payments on the old mortgage.

A wrap-around is attractive to lenders because they can leverage a lower interest rate on the existing mortgage into a higher yield for themselves. For example, suppose the $70,000 mortgage in the example has a rate of 6% and the new mortgage for $95,000 has a rate of 8%. The lender's cash outlay is $25,000 on which he earns 8%, but in addition he earns the difference between 8% and 6% on $70,000. His total return on the $25,000 is about 13.5%. To do as well with a second mortgage, he would have to charge 13.5%. I have a spreadsheet on my web site that calculates the yield on a wrap-around.

Usually, but not always, the lender is the seller. A wrap-around is one type of seller-financing. The alternative type of home-seller financing is a second mortgage. Using the alternative, B obtains a first mortgage from an institution for, say, $70,000, and a second mortgage from S for the additional $25,000 that B needs. The major difference between the two approaches is that with second mortgage financing, the old mortgage is repaid, whereas with a wrap-around it isn't.

In general, only assumable loans are wrappable. Assumable loans are those on which existing borrowers can transfer their obligations to qualified house purchasers. Today, only FHA and VA loans are assumable without the permission of the lender. Other fixed-rate loans carry "due on sale" clauses, which require that the mortgage be repaid in full if the property is sold. Due-on-sale prohibits a home purchaser from assuming a seller's existing mortgage without the lender's permission. If permission is given, it will always be at the current market rate.

Wrapping can be used to circumvent restrictions on assuming old loans, but I don't recommend using it for this purpose. The home seller who does this violates his contract with the lender, which he may or may not get away with. In some states, escrow companies are required by law to inform a lender whose loan is being wrapped. If a wrap-around deal on a non-assumable loan does close and the lender discovers it afterwards, watch out! The lender will either call the loan, or demand an immediate increase in interest rate and probably a healthy assumption fee.

When market interest rates begin to rise, interest in wrapping assumable loans will also rise. The incentive to sellers is powerful, since not only do they acquire a high-yielding investment, but they can often sell their house for a better price. But the high return carries a high risk.

When S in my example sold his house with a wrap-around, he converted his equity from his house, which he no longer owns, to a mortgage loan. Previously, his equity was a $100,000 house less a $70,000 mortgage. Now, his equity consists of the $5,000 down payment plus a $95,000 mortgage that he owns less the $70,000 mortgage that he owes.

The new owner has only $5,000 of equity in the property. If a small decline in market values

erases that equity, the owner has no financial incentive to maintain the property. If the buyer defaults on his mortgage, S will be obliged to foreclose and sell the property to pay off his own mortgage.

In some seller-provided wrap-arounds, the payment by the buyer goes not to the seller but to a third party for transmission to the original lender. This is an extremely risky arrangement for the seller, who remains liable for the original loan. He doesn't know if the payment on the old mortgage was made or not -- until he receives notice from the lender that it wasn't. I recently heard from a seller who did such a wrap-around in 1996, and has been getting the run-around ever since. Payments by the buyer have often been late, and the seller's credit has deteriorated as a result.

Or it can work out well, perhaps 9 of 10 deals do. The problem is that unless you know the buyer, you can never be sure that yours is not the 10th that doesn't. The home seller who does a wrap-around can't diversify his risk.

Source: http://www.mtgprofessor.com/a%20-%20wrap-around%20mortgages/what_is_a_wrap-around_mortgage.htm
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