The interest rate a seller agrees to accept when providing owner financing to the buyer has a large impact on the note's value. Unfortunately, many sellers overlook this important decision.

Here's why the interest rate on a note is such a big deal.

Inflation Fighter
Each year it seems the cost to buy the basics just keeps going up. It's not your imagination; it's inflation. In fact in July 2008 that inflation rate was 5.6 percent higher than in July 2007 (based on the Consumer Price Index reported by the U.S. Department of Labor on August 14, 2008). Worse yet, some basic items like energy increased 29.3% over that same time frame.

So what does inflation have to do with seller-financed notes? Well a seller would need to at least charge an interest rate equivalent to the inflation rate just to break even!

Return on Investment
Rather than just breaking even, a seller desires a return on their investment. By accepting an IOU or payments from the buyer that money is tied up. Plus, once the property is sold the new owner will be the one to directly benefit from any increase in property value.

The seller is now acting as the bank and should expect a return at least equivalent to the interest rate a bank is charging for a similar loan. The seller does not have the protection of private mortgage insurance that many banks require adding another level of risk that should be rewarded by an increased rate.

Since the buyer is saving the costs a traditional bank might charge for a loan (points, underwriting fees, origination fees, etc.) it is reasonable to expect them to pay an interest rate above what a bank would charge. On average, it is recommended that a seller financed note carry an interest rate of 2-4% higher than bank rates to compensate for these matters.

Improves Resale Value

If a note holder ever desires to sell their future note payments for a lump sum of cash, they will quickly realize how important the note interest rate is to investors.

While investors look to a variety of factors to determine their pricing, all things being equal, a higher interest rate results in a higher purchase price from a note investor.

For example, a seller holds a note with a balance of $100,000 with monthly payments of $1,110.21. If the note rate is 6% and the investor wants a 9% yield then the offer would be $87,641. Now if the note rate were 4% the offer would decrease to $81,623, but if the note rate were 8% the offer would increase to $95,274.

For simplicity of comparison, these examples assume the monthly payment amount remains the same and there are acceptable credit, equity, and documentation. But you get the idea, the higher the interest rate the more valuable the note.

There's no Take-Backs!
The time to give serious consideration to the note interest rate is at the time of creation. There are no take-backs or do-overs. The rate you agree to accept at closing stays the interest rate for the life of the note. The only way to change it later is to get the buyer to agree and execute a formal note modification. It's highly unlikely a buyer or note payer is going to agree to have their interest rate increased at a later date (unless there is some advantage to them).

Be sure to give the amount of interest charged on a seller financed note serious thought. It will affect the value of your note not only today, but also far into the future.

About the Author:
Tracy Z. Rewey has been using seller financing for over 20 years. She's helped thousands of buyers, sellers, and brokers achieve their goals, even in a tough economy.