

17 Real Estate Finance

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ANATOMY OF MORTGAGE LENDING

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Mechanics of a loan transaction

It is common to use borrowed money to purchase real estate. When a borrower gives a note promising to repay the borrowed money and executes a mortgage on the real estate for which the money is being borrowed as security, the financing method is called mortgage financing. The term "mortgage financing" also applies to real estate loans secured by a deed of trust. The process of securing a loan by pledging a property without giving up ownership of the property is called **hypothecation**.

States differ in their interpretation of who owns mortgaged property. Those that regard the mortgage as a lien held by the mortgagee (lender) against the property owned by the mortgagor (borrower) are called **lien-theory** states. Those that regard the mortgage document as a conveyance of ownership from the mortgagor to the mortgagee are called **title-theory** states. Some states interpret ownership of mortgaged property from a point of view that combines aspects of both title and lien theory.

A valid mortgage or trust deed financing arrangement requires

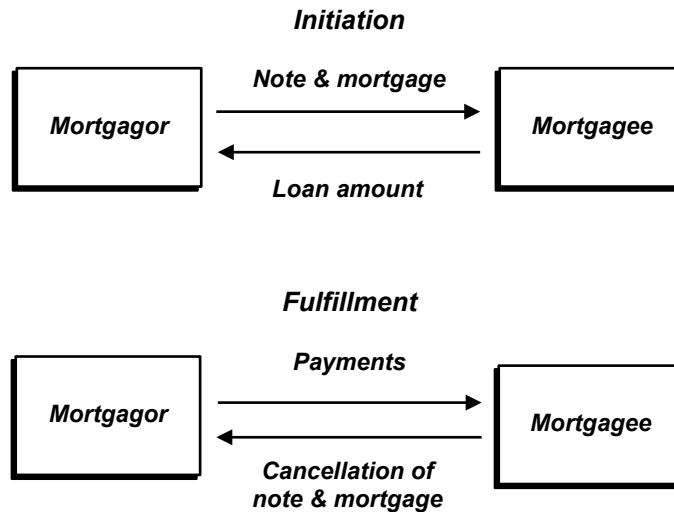
- ▶ a *note* as evidence of the debt
- ▶ the *mortgage or trust deed* as evidence of the collateral pledge

Note. In addition to executing a mortgage or trust deed, the borrower signs a promissory note for the amount borrowed. The amount of the loan is typically the difference between the purchase price and the down payment. A promissory note creates a personal liability for the borrower to repay the loan.

Mortgage. A mortgage is a legal document stating the pledge of the borrower (the **mortgagor**) to the lender (the **mortgagee**). The mortgage document pledges the borrower's ownership interest in the real estate in question as collateral against performance of the debt obligation.

The flow of funds and obligations in a mortgage transaction is as follows:

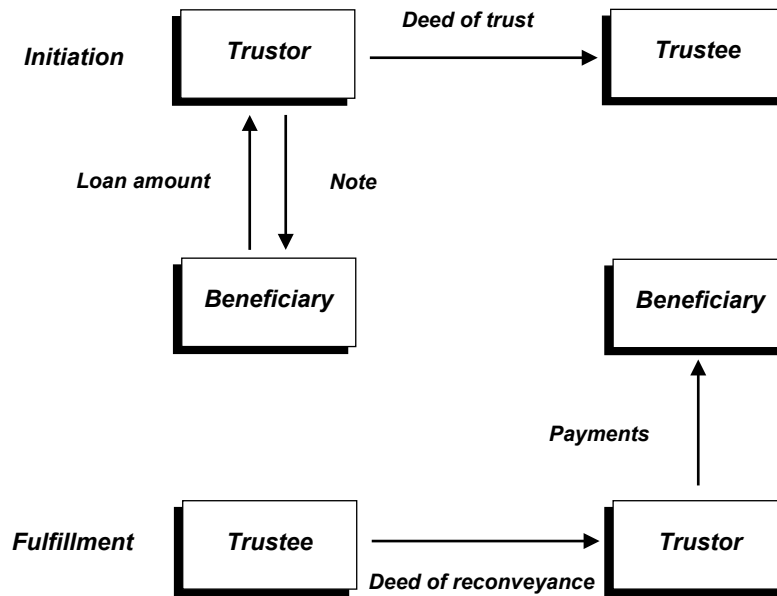
Exhibit 17.1 Flow of a Mortgage Transaction



The deed of trust. A deed of trust conveys title to the property in question from the borrower (**trustor**) to a **trustee** as security for the loan. The trustee is a third party fiduciary to the trust. While the loan is in place, the trustee holds the title on behalf of the lender, who is the **beneficiary** of the trust. On repayment of the loan, the borrower receives the title from the trustee in the form of a deed of reconveyance.

The flow of funds and obligations in a trust deed transaction is as follows:

Exhibit 17.2 Flow of a Trust Deed Transaction



Financial components of a loan

The financial components of a mortgage loan include:

- principal
- interest and interest rate
- points
- term
- payments

Principal. The capital amount borrowed, on which interest payments are calculated, is the original loan **principal**. In an amortizing loan, part of the principal is repaid periodically along with interest, so that the principal balance decreases over the life of the loan. At any point during the life of a mortgage loan, the remaining unpaid principal is called the **loan balance**, or **remaining balance**.

Interest and interest rate. Interest is a charge for the use of the lender's money. Interest may be paid in *advance* at the beginning of the payment period, or in *arrears* at the end of the payment period, according to the terms of the note. Mortgage interest is most commonly paid in arrears. The **interest rate** is a percentage applied to the principal to determine the amount of interest due. The rate may be *fixed* for the term of the loan, or it may be *variable*, according to the terms of the note. A loan with a fixed interest rate is called a fixed-rate loan; a loan with a variable interest rate is commonly called an adjustable rate loan.

Because the interest rate on a mortgage loan does not reflect the full cost of the loan to the borrower, federal law requires a lender on a residential property to compute and disclose an **Annual Percentage Rate (APR)** that includes other finance charges in addition to the basic interest rate in the calculation.

Many states have laws against **usury**, which is the charging of excessive interest rates on loans. Such states have a maximum rate that is either a flat rate or a variable rate tied to an index such as the prime lending rate.

Points. From the point of view of a lender or investor, the amount loaned in a mortgage loan is the lender's capital investment, and the interest paid by the borrower is the return earned by the invested capital. It is often the case that a lender needs to earn a greater return than the interest rate alone provides. For example, a lender may require additional yield on a low-interest VA loan which has an interest rate maximum. In such a case, the lender charges up-front **discount points** to make up the difference between the interest rate on the loan and the required return. This effectively raises the yield of the loan to the lender.

A discount point is *one percent of the loan amount*. Thus, one point on a \$100,000 loan equals \$1,000. The lender charges this as *pre-paid interest* at closing by funding only the face amount of the loan minus the discount points. The borrower, however, must repay the full loan amount, along with interest calculated on the full amount.

The value of one discount point to a lender is usually estimated to be equivalent to raising the interest rate on the loan by 1/8%. Thus, a lender has to charge eight points to raise the yield by 1%. If a lender needs to earn 7% on a loan offered at 6.5%, the number of points necessary would be figured as follows:

$$\begin{aligned} 7.0\% - 6.5\% &= .5\% \\ .5\% \times 8 \text{ (points per 1\%)} &= 4 \text{ points} \end{aligned}$$

On a loan of \$100,000, the 4 points would cost the borrower:

$$100,000 \times .04 = \$4,000.$$

The borrower would effectively receive from the lender \$96,000, and owe principal and interest based on \$100,000. For tax reasons, it is usually advisable for the borrower to receive the full loan amount from the lender and pay the points in a check which is separate from that used for other closing costs. As pre-paid interest, points paid in this way may be deductible on the borrower's income tax return for the year of the purchase. The borrower should seek the advice of a tax consultant concerning this matter.

Term. The loan term is the period of time over which the loan must be repaid. A "30-year loan" is a loan whose balance must be fully paid off at the end of thirty years. A "five-year balloon loan" is a loan whose balance must be paid off at the end of five years, although its payments may be calculated on a term of another length, such as fifteen or thirty years. Such a loan is also sometimes described as a 30-year loan with a five-year "call."

Payments. The loan term, loan amount, and interest rate combine to determine the periodic payment amount. When these three quantities are known, it is possible to identify the periodic payment from a mortgage table or with a financial calculator. Mortgage payments are usually made on a monthly basis. On an amortizing loan, a portion of the payment goes to repay the loan balance in advance, and a portion goes to payment of interest in arrears.

For example, Mary and Jerry King borrow \$400,000 to finance the purchase of a home. The loan has a term of thirty years at an interest rate of 5% and is amortizing. The monthly payment for this loan will be \$2,147. For the first payment at the end of the month, the Kings owe interest on \$400,000 for the monthly period. At 5%, this amounts to \$1,666.67. Since their payment is \$2,147 and the interest charge is \$1,666.67, the difference, which is \$480.33, is applied to an advance payment of principal. The following month, the Kings will pay interest on the new, smaller loan balance of \$399,519.67 (\$400,000.00 – 480.33).

If a borrower pays more than the scheduled payment amount, the excess is credited to repayment of the principal, which is reduced by the amount of the excess payment. The required minimum payment amount remains constant for the life of the loan, but the loan term can be reduced by this means, thereby also reducing the total amount of interest paid over the life of the loan.

Promissory note

A borrower who executes a promissory note is the **maker** or **payer** of the note. The lender is the **payee**. To be properly executed, all parties who have an interest in the property should sign the note. The note sets forth:

- ▶ the loan amount
- ▶ the term of the loan
- ▶ the method and timing of repayment
- ▶ the interest rate to be paid
- ▶ the borrower's promise to pay

The note may also state that it is payable to the bearer, if used with a deed of trust, or to the mortgagee, if used with a mortgage. Other items in the mortgage document or deed of trust may be repeated in the promissory note, especially:

- ▶ the right to prepay the loan balance
- ▶ charges for late payment
- ▶ conditions for default
- ▶ notifications and cures for default
- ▶ other charges

A promissory note is a **negotiable instrument**, which means the payee may *assign* it to a third party. The assignee would then have the right to receive the borrower's periodic payments.

Mortgage document and trust deed

A borrower who executes a mortgage is a **mortgagor**. The lender named in the mortgage is the **mortgagee**. In a trust deed, the borrower is the **trustor** and the lender is **beneficiary**. The mortgage or trust document identifies the property being given as security, giving both its legal description and mailing address. The document contains much of the same information as the note, including:

- ▶ the debt amount
- ▶ the term of the loan
- ▶ method and timing of payments

The document does not usually provide details about the payment amount, interest rate, or charges.

Among the major clauses of a typical mortgage are the following.

Payment of Principal and Interest: Prepayment and Late Charges. The borrower must make timely payments according to the terms of the note.

Funds for Taxes and Insurance. Unless waived by the lender or prohibited by law, the borrower must make monthly payments to cover taxes and hazard insurance. If applicable, the borrower must also pay flood insurance and mortgage insurance installments.

Periodic payments of taxes and insurance are held in a reserve fund called the **escrow account**. The Real Estate Settlement Procedures Act (RESPA) limits the amount of funds that the lender can require and hold for this purpose.

The borrower's monthly payment to the lender for principal and interest is called the **P&I** payment (principal and interest). The amount which also includes the escrow payment is called **PITI** (principal, interest, taxes, insurance).

Application of Payments. The amount of each payment is applied to various items in order of priority. Unless local law provides otherwise, this order is: 1) prepayment charges; 2) escrow; 3) interest; 4) principal; 5) late charges.

Charges and Liens. The borrower is liable for paying any charges, liens, or other expenses that may have priority over the mortgage or trust instrument.

Hazard or Property Insurance. The borrower must keep the property insured as the lender requires to protect the lender's collateral. **Homeowners' insurance** policies typically provide coverage for losses due to fire, lightning, wind, hail, explosions, glass breakage, smoke, riots, vandalism, theft, and other perils. Insurance proceeds, in case of a claim, are applied first to restoring the property, or, if that is not feasible, to payment of the debt.

Occupancy, Preservation, Maintenance and Protection of the Property. The borrower must take and maintain occupancy of the property as the borrower's principal residence according to the lender's requirements. The borrower must not use or neglect the property in such a way as to impair the lender's lien on the property. This could include using the property for illegal purposes, creating hazardous waste on the property, or destroying the improvements.

Protection of Lender's Rights in the Property. The lender may take actions it believes are necessary to protect its rights in the property if the borrower's actions threaten them. The costs of these actions would be charged to the borrower, and become part of the monthly payment.

Mortgage Insurance. The lender may require the borrower to obtain **private mortgage insurance**, or **PMI**. Mortgage insurance protects the lender against loss of a portion of the loan (typically 20-25%) in case of borrower default. Private mortgage insurance generally applies to loans that are not backed by the Federal Housing Administration (FHA) or Veterans Administration (VA) and that have a down payment of less than 20% of the property value.

Inspection. With proper notice, the lender may inspect the property if there is reasonable cause to fear damage to its lien.

Condemnation. If the property is condemned or taken by eminent domain, the lender declares a claim on any resulting proceeds.

Borrower Not Released; Forbearance by Lender Not a Waiver. The lender reserves the right to take future action against the borrower for default, even if the lender decides not to take immediate action. If the lender agrees to change the terms of the loan, it does not release the borrower from the original liability.

Transfer of the Property or a Beneficial Interest in Borrower. If the borrower sells or transfers its interest in the property without the lender's approval, the lender may demand immediate and full repayment of the loan balance. This is an **alienation** clause, also known as a **due-on-sale** clause and a **call** clause. It allows the lender to prevent the assumption of the mortgage by a buyer if the borrower sells the property. The requirement to repay the loan before the scheduled date is called **acceleration**.

Borrower's Right to Reinstate. If the lender holds the borrower in default under the terms of the mortgage and proceeds to enforce its rights under the document, such as by foreclosing, the borrower has the right to reinstate his or her interest by performing certain actions. This usually means paying overdue mortgage payments and any other expenses the lender may have incurred in protecting its rights. The clause, also known as a **redemption** clause, gives the borrower a period of time to satisfy obligations and prevent the lender from forcing a sale of the property. See **foreclosure** on [page 68](#) in Chapter Five.

Release. The lender agrees to release the mortgage or trust document to the borrower when the borrower has paid off the loan and all other sums secured by the document. The release clause, also known as a **defeasance** clause, may specify that the mortgagee will execute a **satisfaction of mortgage** (also known as **release of mortgage** and **mortgage discharge**) to the mortgagor. In the case of a deed of trust, the lender as beneficiary requests the trustee to execute a **release deed** or **deed of reconveyance** to the borrower as trustor. The release deed or satisfaction should be recorded as necessary in county records to show that the mortgagee/trustee has extinguished all liens against the property.

INITIATING A MORTGAGE LOAN

The loan application Mortgage loan underwriting

The process of initiating a mortgage loan begins when a borrower completes a loan application and submits it to a lender for evaluation by the lender's underwriters.

The loan application **Forms.** Most lenders use some version of the "Uniform Residential Loan Application" promulgated by Fannie Mae. This form requests the borrower to provide information about the property and the borrower. In addition, the

application must include supporting documentation, as indicated in the following exhibit.

Exhibit 17.3 Property and Borrower Information

Property information	age & year built original cost	year acquired current loan balance
Borrower information	age employment history assets	education monthly income & expenses debts
Supporting documentation	appraisal report purchase contract	credit report income and employment verification

The standard form includes the loan amount requested, based on an estimate of the purchase, refinance, or other underlying transaction.

Completion. The application must be complete for the lender to consider it. The form must be signed and dated by the applicant(s) and delivered to the lending institution. The **initiation** of the application process occurs when the lender receives the completed application package from the applicant. Federal law requires the lender to accept all applications and to give applicants notice concerning the disposition of the application. If the lender denies the loan application because of fraudulent information on the application form, the borrower has no claim to a refund of the application fee.

Mortgage loan underwriting

Loan underwriting is the process of assessing the lender's risk in giving a loan. Mortgage underwriting includes:

- ▶ evaluating the borrower's ability to repay the loan
- ▶ appraising the value of the property offered as security
- ▶ determining the terms of the loan

Risk. A lender undertakes a number of risks in lending money. The principal risks are that the borrower will default on repayment of the loan, and that the borrower will damage the value of the property as security. In addition, the lender runs the risk that, in the event of a foreclosure, the sales proceeds from the property will be insufficient to cover the lender's loss.

Qualification. A lender assesses risks by examining, or *qualifying*, both borrower and property. In qualifying a borrower, an underwriter weighs the ability of the borrower to repay the loan. This requires an analysis of whether the borrower's income, cash resources, creditworthiness, net worth, and employment stability meet the lender's standards.

Loan-to-value ratio, or LTV. In qualifying a property, an underwriter assesses the ability of the property value to cover potential losses. In this evaluation, a lender requires that the appraised value of the property be more than adequate to

cover the contemplated loan and costs. To protect further against loss, a lender will usually lend only a portion of the property's value. The relationship of the loan amount to the property value, expressed as a percentage, is called the **loan-to-value ratio, or LTV**. If the lender's loan to value ratio is 80%, the lender will lend only \$80,000 on a home appraised at \$100,000. The difference between what the lender will lend and what the borrower must pay for the property is the amount the borrower must provide in cash as a down payment.

Even if borrower and property qualify, a lender may, under certain circumstances, seek further protection against risk by requiring the borrower to obtain private mortgage insurance. This is frequently the case with loans requiring a relatively small down payment, leading to a high loan-to-value ratio.

Private mortgage insurance. As mentioned earlier, if a loan's LTV ratio is too high, a lender may require that the borrower purchase private mortgage insurance, commonly called PMI. This insurance secures whatever portion of the loan amount takes the LTV ratio above the typical ratio limit – which is usually 80% of the property's value. This protects the lender from the borrower's default – which can become more likely if the borrower has very little equity in the property.

To illustrate, take a \$500,000 property with an 90-10% LTV loan on it. At 90%, this loan would be 90% times \$500,000, or \$450,000. Next, consider that the lender requires 20% equity, or an 80-20% LTV. Such an LTV would cap the loan limit at \$400,000. In this case, to get this lender to lend \$450,000, the borrower would have to purchase PMI to insure the "top" portion of the loan, or \$50,000. With this PMI safety net, the lender can lend the funds, and the borrower closes with a 90-10 LTV loan.

In practice, a borrower who has to obtain PMI must retain the insurance policy and continue the premium payments until the LTV ratio on the loan has dropped to within acceptable levels, such as the 80-20 level. This happens by the property's value appreciating as well as the loan balance being paid off over time. Finally, if the borrower can assimilate enough funds to pay down the loan balance, the lender will be obligated to drop the PMI requirement, since, as we have seen, a prepayment of principal changes the loan-to-value ratio.

QUALIFYING FOR A MORTGAGE LOAN

Equal Credit Opportunity Act

Income qualification

Loan constant

Cash qualification

Net worth

Credit evaluation

Loan commitment

To qualify for a mortgage loan, a borrower must meet the lender's qualifications in terms of *income, debt, cash, and net worth*. In addition, a borrower must demonstrate sufficient *creditworthiness* to be an acceptable risk.

Equal Credit Opportunity Act

The Equal Credit Opportunity Act (ECOA) requires a lender to evaluate a loan applicant on the basis of that applicant's own income and credit rating, unless the applicant requests the inclusion of another's income and credit rating in the application. In addition, ECOA has prohibited a number of practices in mortgage loan underwriting. Accordingly, a lender may not:

- ▶ discount or disregard income from part-time work, a spouse, child support, alimony, or separate maintenance. Further, the loan officer may not ask whether any of the applicant's income is derived from these sources.
- ▶ assume that income for a certain type of person will be reduced because of an employment interruption due to child-bearing or child-raising. The loan officer may not ask about the applicant's plans or behavior concerning child-bearing or birth control.
- ▶ refuse a loan solely on the basis that the security is located in a certain geographical area.
- ▶ ask applicants any question about their age, sex, religion, race or national origin, except as the law may require.
- ▶ require a spouse to sign any document unless the spouse's income is to be included in the qualifying income, or unless the spouse agrees to become contractually obligated, or the state requires the signature for some purpose such as clearing clouded title.

If a lender denies a request for a loan, or offers a loan under different terms than those requested by an applicant, the lender must give the applicant written notice providing specific reasons for the action.

Qualifying the borrower. The lender must rely on eight types of information to determine that the borrower has the ability to repay the loan:

1. current income or assets (excluding the value of the mortgaged property)
2. current employment status
3. credit history
4. monthly payment for the mortgage
5. monthly payments being made on other loans on the same property
6. monthly payments for other mortgage-related expenses
7. other debts
8. monthly debt payments compared to monthly income (debt-to-income ratio)

The lender cannot use a temporarily low rate (introductory or “teaser” rate) to determine qualification. For an adjustable rate mortgage (ARM), the highest rate the borrower might have to pay is generally to be used.

The “ability to repay” requirements are relaxed in certain circumstances where the borrower is attempting to refinance from a riskier loan (such as an interest-only loan) to a less risky one (such as a fixed-rate mortgage loan).

Qualified Mortgage. A Qualified Mortgage is one that meets the “ability-to-repay” requirements, has certain required features and is not allowed to have others. There are exceptions to these rules for certain kinds of small lenders. Issuing a Qualified Mortgage gives the lender certain legal protections in case the borrower fails to repay the loan.

Generally not allowed:

- ▶ an “interest-only” period--when interest, but not principal, is being repaid
- ▶ negative amortization--when principal increases over time
- ▶ balloon payment--larger than normal payment at the end of the loan term
- ▶ loan term longer than 30 years
- ▶ excessive upfront fees and points

Generally required:

- ▶ monthly debt no more than 43 % of monthly pre-tax income
- ▶ limits on points

Qualified Mortgages include loans that can be bought by Fannie Mae or Freddie Mac or insured by certain government agencies, such as the Department of Agriculture, even if the debt ratio is higher than 43 percent. Also, loans that are insured or guaranteed by the Department of Housing and Urban Development, including through the Federal Housing Administration, are qualified mortgages under rules issued by that agency.

Valuations. Before issuing a first mortgage loan, a lender must

- ▶ notify the borrower within three days of the loan application that a copy of any appraisal will be promptly provided
- ▶ provide the borrower with a free copy of any valuation used, including appraisal reports, automated valuation model reports, and broker’s price opinions, promptly when completed and no later than three days before closing
- ▶ provide these copies even if the loan does not close

The lender may ask for the deadline to be waived so that the copies may be delivered at closing, and may charge a reasonable fee for obtaining the valuation.

Discovery and disclosure requirements. Creditors are required to provide applicants with free copies of all appraisals and other written valuations developed in connection with an application for a loan to be secured by a first lien on a dwelling and must notify applicants in writing that copies of appraisals will be provided to them promptly.

High cost loans. When the annual percentage rate (APR) or points and fees on a home loan, home equity loan, or home equity line of credit (HELOC) exceed certain limits, special consumer protections apply. The lender must provide information in advance that explains the costs, terms, and associated fees, and get a housing counselor to certify that the borrower has received counseling about the high-cost mortgage.

With high-cost mortgages, lenders are not allowed to add many kinds of fees and charges to the loan amount, namely:

- ▶ prepayment penalties for early loan payoff
- ▶ balloon payments
- ▶ late fees larger than 4 percent of the regular payment
- ▶ fees for payoff statements (statements of loan balance)
- ▶ loan modification fees

Income qualification

Lenders want to be assured that the borrower has adequate means to make all necessary periodic payments on the loan in addition to other housing expenses and debts such as credit card payments and car payments. Most lenders use two ratios to estimate an applicant's ability to fulfill a loan obligation: an *income ratio*, or *housing ratio*, and a *debt ratio*, or *housing plus debt ratio*. They also consider the stability of an applicant's income. Please note that the income and debt ratios in the discussion below do not necessarily reflect the latest ratios used by FHA, VA, or other lenders. Check for updates on the websites of those agencies.

Income ratio. The income ratio, or housing expense ratio, establishes borrowing capacity by limiting the percent of gross income a borrower may spend on housing costs. Housing costs include principal, interest, taxes, and homeowner's insurance, and may include monthly assessments, mortgage insurance, and utilities. The income ratio formula is:

Income Ratio

$$\frac{\text{monthly housing expense}}{\text{monthly GROSS income}} = \text{income ratio}$$

To identify the maximum monthly housing expense an income ratio allows, modify the formula as follows:

$$\text{monthly gross income} \times \text{income ratio} = \text{monthly housing expense}$$

Most conventional lenders require that this ratio be *no greater than 25-28%*. In other words, a borrower's total housing expenses cannot exceed 28% of gross income. For an FHA-backed loan, the ratio is 31%. VA-guaranteed loans do not use this qualifying ratio.

For example, if a couple has combined monthly gross income of \$12,000, and a lender's maximum income ratio is 28%, the couple's monthly housing expense cannot exceed \$3,360:

$$\$12,000 \times 28\% = \$3,360$$

Debt ratio. The debt ratio considers all of the monthly obligations of the income ratio *plus any additional monthly payments the applicant must make for other debts*. The lender will look specifically at minimum monthly payments due on revolving credit debts and other consumer loans. The debt ratio formula is:

Debt Ratio

$$\frac{\text{monthly housing expense} + \text{monthly debt obligations}}{\text{monthly GROSS income}} = \text{debt ratio}$$

To identify the housing expenses plus debt a debt ratio allows, modify the formula as follows:

$$\text{monthly gross income} \times \text{debt ratio} = \text{monthly housing expense} + \text{monthly debt obligations}$$

Most conventional lenders require that this debt ratio be *no greater than 36%*. For an FHA-backed loan, the debt ratio may not exceed 43%. The VA uses 41% and a variable “residual income” calculation. The FHA and VA include in the debt figure any obligation costing more than \$100 per month and any debt with a remaining term exceeding six months.

Using the 36% debt ratio, the couple whose monthly income is \$12,000 will be allowed to have monthly housing and debt obligations of \$4,320:

$$\$12,000 \text{ gross income} \times 36\% = \$4,320 \text{ expenses and debt}$$

VA-guaranteed loans also require a borrower to meet certain qualifications based on net income after paying federal, state, and social security taxes, housing maintenance and utilities expenses. Such **residual income requirements** vary by family size, loan amount, and geographical region.

Income stability. A lender looks beyond income and debt ratios to assess an applicant's income stability. Important factors are:

- ▶ how long the applicant has been employed at the present job
- ▶ how frequently and for what reasons the applicant has changed jobs in the past
- ▶ how likely secondary income such as bonuses and overtime is to continue on a regular basis
- ▶ how educational level, training and skills, age, and type of occupation may affect the continuation of the present income level in the future.

Loan constant

A loan constant is a pre-calculated, unchanging number that relates the principal and interest payment amount of a loan to the amount of the loan at a given interest rate and term.

With the loan constant in hand, one can easily derive

- ▶ the amount of a loan from its principal and interest payment
- ▶ the amount of the principal and interest payment from the loan amount .

By way of these calculations, homebuyers can easily determine how much they can pay per month on a loan or how much loan they can get given their payment affordability. By extension, they can answer two essential homebuyer questions: (a) Can I afford to buy that house? And (b) How much house can I afford to buy?

Loan constants are presented as the monthly payment amount in dollars needed to amortize a loan of a \$1,000 for a certain term at a certain interest rate. The constant must be multiplied by the number of thousands in the loan amount to derive a monthly payment for a larger loan amount. Loan constants can be found in readily available loan constant tables, such as the following.

Monthly Payment Needed to Amortize a \$1,000 loan (Loan Constant)

Interest Rate	Loan Term in Years				
	10	15	20	25	30
3.0	9.65	6.9	5.54	4.74	4.21
3.5	9.88	7.14	5.79	5	4.49
4.0	10.13	7.4	6.06	5.28	4.78
4.5	10.37	7.65	6.33	5.56	5.07
5.0	10.61	7.91	6.6	5.85	5.37
5.5	10.86	8.18	6.88	6.15	5.68
6.0	11.1	8.44	7.16	6.44	6
6.5	11.35	8.71	7.46	6.75	6.32
7.0	11.61	8.99	7.75	7.07	6.65

Solving for the monthly principal and interest payment (PI). The periodic principal and interest payment (PI) on an amortized loan is the total of the payments for interest and principal over that period. In the following examples, the derived number PI does not include any escrow amounts for taxes or interest.

To derive a monthly payment for a given loan amount, interest rate, and term, select the loan constant for that loan from the “Monthly Payment Needed to Amortize a Loan of \$1,000” charts. Then multiply *the number of thousand dollar increments in the loan amount (in other words, the loan amount divided by 1,000) by the loan constant.*

$$\begin{aligned}
 & \text{(Loan amount } L \div 1,000) \times \text{Constant } C = \text{Payment PI} \\
 & \text{OR} \\
 & (L \div 1,000) \times C = PI
 \end{aligned}$$

1. A borrower's interest rate is 5.5% and she needs a 30-year loan in the amount of \$350,000. What will her monthly PI payment be?

Answer

- (a) the monthly loan constant C for a 30-year loan at 5.5% is **5.68**.
- (b) the monthly PI payment for a **\$350,000** loan = $(\$350,000 \div 1,000) \times 5.68$
 $5.68 \text{ C} = (350 \times 5.68) = \text{\$1,988.00 PI}$

2. A borrower's interest rate is 6.0% and she prefers to get a 20-year loan. To buy the house, she must borrow \$280,000. What will her payment be?

Answer

- (a) the monthly loan constant C for a 20-year loan at 6.0% is **7.16**.
- (b) the monthly PI payment for a **\$280,000** loan $L = (280,000 \div 1,000) \times 7.16$
 $7.16 \text{ C} = (280 \times 7.16) = \text{\$2,004.80 PI}$

Solving for the loan amount. The loan amount in the present context is the beginning principal balance of the loan.

To derive a loan amount when you know the monthly PI payment, the interest rate and the term, identify the loan's constant, divide the PI amount by that constant, *then multiply the result by 1,000*.

$$(\text{Payment PI} \div \text{Constant C}) \times 1,000 = \text{Loan amount L}$$

or

$$(\text{PI} \div \text{C}) \times 1,000 = \text{L}$$

1. A borrower's interest rate is 5.5% and he wants a 30-year loan. His banker said he could afford to pay \$1,988 PI per month. How much can he borrow at this budget (to the nearest thousand)?

Answer

- (a) the monthly loan constant C for a 30-year loan at 5.5% is **5.68**.
- (b) the loan amount L = payment PI **\$1,988** $\div$ loan constant C **5.68** $\times 1000$
 $= \text{\$350,000 L}$.

2. A borrower's interest rate is 6.0% and she prefers to get a 20-year loan. Her banker said she could afford a monthly PI payment of \$2,000. How much can she borrow with this payment budget?

Answer

- (a) the monthly loan constant C for a 20-year loan at 6.0% is **7.16**.
- (b) the loan amount L = payment PI **\$2,000** $\div$ loan constant C **7.16** $\times 1,000 = \$279,329$, or **\$280,000** rounded.

Cash qualification Since a lender lends only part of the purchase price of a property according to the lender's loan-to-value ratio, a lender will verify that a borrower has the cash resources to make the required down payment. If some of a borrower's cash for the down payment comes as a gift from a relative or friend, a lender may require a **gift letter** from the donor stating the amount of the gift and lack of any requirement to repay the gift. On the other hand, if someone is lending an applicant a portion of the down payment with a provision for repayment, a lender will consider this another debt obligation and adjust the debt ratio accordingly. This can lower the amount a lender is willing to lend.

Net worth An applicant's **net worth** shows a lender the depth of the applicant's cash reserves, the value and liquidity of assets, and the extent to which assets exceed liabilities. These facts are important to a lender as an indication of the applicant's ability to sustain debt payment in the event of loss of employment.

Credit evaluation **Credit report and credit score.** A lender must obtain a written credit report on any applicant who submits a completed loan application. The credit report will contain the applicant's history regarding:

- ▶ outstanding debts
- ▶ payment behavior (timeliness, collection problems)
- ▶ legal information of public record (lawsuits, judgments, bankruptcies, divorces, foreclosures, garnishments, repossessions, defaults)

Problems with payment behavior and legal actions are likely to cause a lender to deny the application, unless the applicant can provide an acceptable explanation of mitigating and temporary circumstances that caused the problem.

If a lender denies a loan on the basis of a credit report, the lender must disclose in writing that the applicant is entitled to a statement of reason from any creditor responsible for the negative report.

Since 1995, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association have been encouraging lenders to use *credit scoring* to evaluate loan applicants. **Credit scoring** is a computer-based method of assigning a numerical value to an applicant's credit. The credit score is a statistical prediction of a borrower's likelihood of defaulting on a loan.

Loan commitment When a lender's underwriters have qualified an applicant and the lender has decided to offer the loan, the lender gives the applicant a written notice of the agreement to lend under specific terms. This written promise is the **loan commitment**. The commitment may take a number of common forms, including *a firm commitment, a lock-in commitment, a conditional commitment, and a take-out commitment*.

A **firm commitment** is a straight forward offer to make a specific loan at a specific interest rate for a specific term. This kind of commitment is the one most commonly offered to home buyers.

A **"lock-in" commitment** is an offer to lend a specific amount for a specific term at a specific interest rate, *but the interest rate is subject to an expiration*

date, for instance, sixty days. This guarantees that the lender will not raise the interest rate during the application and closing periods. The borrower may have to pay points or some other charge for the lock-in.

A **conditional commitment** offers to make a loan if certain provisions are met. This kind of commitment generally applies to construction loans. A typical condition for funding the loan is completion of a development phase.

A **take-out commitment** offers to make a loan that will "take out" another lender's loan, i.e., pay it off and replace it. The take-out loan is most often used to retire a construction loan. The take-out lender agrees to pay off the short-term construction loan by issuing a long-term permanent loan.

CLOSING A LOAN

Closing of a mortgage loan normally occurs with the closing of the real estate transaction. At the real estate closing, the lender typically has deposited the funded amount with an escrow agent, along with instructions for disbursing the funds. The borrower deposits necessary funds with the escrow agent, executes final documents, and receives signed copies of all relevant documents.

Title to the mortgaged property is transferred and recorded according to legal procedures in effect at the time of closing. The borrower receives a package containing copies of all documents relevant to the transaction.

LAWS AFFECTING MORTGAGE LENDING

Truth-in-Lending and Regulation Z
Equal Credit Opportunity Act
Real Estate Settlement Procedures Act
National Flood Insurance Act

Truth-in-Lending and Regulation Z

The Consumer Credit Protection Act, enacted in 1969 and since amended by the Truth-in-Lending Simplification and Reform Act, is implemented by the Federal Reserve's **Regulation Z**. Regulation Z applies to all loans secured by a residence. It does not apply to commercial loans or to agricultural loans over \$25,000. Its provisions cover *the disclosure of costs, the right to rescind the credit transaction, advertising credit offers, and penalties for non-compliance with the act*.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Consumer Financial Protection Bureau (CFPB) to protect consumers by carrying out federal consumer financial laws. The CFPB consolidates most Federal consumer financial protection authority in one place, including enforcement of RESPA, ECOA, and Truth in Lending.

Disclosure of costs. Under Regulation Z, a lender must disclose all finance charges as well as the true Annualized Percentage Rate (APR) in advance of closing. A lender does not have to show the total interest payable over the loan term or include in finance charges such settlement costs as fees for appraisal,

title, credit report, survey, or legal work. Disclosure must be distinctly presented in writing.

Rescission. A borrower has a limited right to cancel the credit transaction, usually within three days of completion of the transaction. The right of rescission does not apply to "residential mortgage transactions," that is, to mortgage loans used to finance the purchase or construction of the borrower's primary residence. However, state law may require a rescission period and notice on these transactions as well.

Advertising. Any type of advertising to offer credit is subject to requirements of full disclosure if it includes:

- ▶ a down payment percentage or amount
- ▶ an installment payment amount
- ▶ a specific amount for a finance charge
- ▶ a specific number of payments
- ▶ a specific repayment period
- ▶ a statement that there is no charge for credit

If any of these items appears in the advertising, the lender must disclose the down payment amount or percentage, repayment terms, the APR, and whether the rate can be increased after consummation of the loan.

Noncompliance. Willful violation of Regulation Z is punishable by imprisonment of up to a year and/or a fine of up to \$5,000. Other violations may be punished by requiring payment of court costs, attorneys' fees, damages, and a fine of up to \$1,000.

Equal Credit Opportunity Act

ECOA prohibits discrimination in extending credit based on race, color, religion, national origin, sex, marital status, age, or dependency upon public assistance. A creditor may not make any statements to discourage an applicant on the basis of such discrimination or ask any questions of an applicant concerning these discriminatory items. A real estate licensee who assists a seller in qualifying a potential buyer may fall within the reach of this prohibition. A lender must also inform a rejected applicant in writing of reasons for denial within 30 days. A creditor who fails to comply is liable for punitive and actual damages.

Real Estate Settlement Procedures Act

RESPA is a federal law which aims to *standardize settlement practices and ensure that buyers understand settlement costs*. RESPA applies to purchases of residential real estate (one- to four-family homes) to be financed by "federally related" first mortgage loans. Federally related loans include:

- ▶ VA- and FHA-backed loans
- ▶ other government-backed or -assisted loans
- ▶ loans that are intended to be sold to FNMA, FHLMC, GNMA, or other government-controlled secondary market institutions
- ▶ loans made by lenders who originate more than one million dollars per year in residential loans.

In addition to imposing settlement procedures, RESPA provisions prohibit lenders from paying kickbacks and unearned fees to parties who may have helped the lender obtain the borrower's business. This would include, for example, a fee paid to a real estate agent for referring a borrower to the lender.

To assist in informing and educating borrowers, RESPA requires that lenders provide a loan applicant with a **loan information booklet** and a **loan estimate**. The booklet, produced by the Consumer Financial Protection Bureau, explains RESPA provisions, general settlement costs, and the required **Closing Disclosure** form. The lender must provide the estimate of closing costs within three days following the borrower's application. RESPA is discussed further in the chapter on "Closings."

Disclosures. The Consumer Financial Protection Bureau (CFPB) requires lenders to use two specific forms to disclose settlement costs to the buyer. A lender must provide a Loan Estimate (H-24) within three days of receiving the loan application and allow the buyer to see the Closing Disclosure (H-25) three days before loan consummation. A lender must also provide a buyer with a copy of the information booklet, "Your Home Loan Toolkit," concerning mortgage loan, closing costs and closing procedures. The disclosures specify:

- ▶ settlement charges
- ▶ title charges
- ▶ recording and transfer fees
- ▶ reserve deposits required
- ▶ tax and insurance escrow deposits required
- ▶ any other fees or charges
- ▶ total closing costs

The disclosure forms vary, depending on loan type. The costs in the Closing Disclosure must match those in the Loan Estimate within certain standards. A sample of the H-25 Closing Disclosure is provided in Chapter 21.

National Flood Insurance Act

Federal law requires that borrowers seeking to finance real estate through federally related loans obtain flood insurance if the property is located in a designated flood-hazard area. The Department of Housing and Urban Development administers a program to subsidize flood insurance for borrowers in communities that have entered the program and complied with its construction standards. The Army Corps of Engineers has prepared flood-zone maps for the entire country.

THE MORTGAGE MARKET

Supply and demand for money

The primary mortgage market

The secondary mortgage market

Role of FNMA, GNMA, FHLMC AND FAMC

Mortgage loans provide borrowers with funds to purchase real estate. Money for mortgages primarily comes from cash savings of individuals, government, and

businesses. This money may become available through the process of **intermediation**, in which funds on deposit with financial institutions are loaned out to borrowers, or **disintermediation**, in which the owners of the savings invest their money directly by making loans or other investments. Government actions and investor activities affect the supply of money for mortgage loans and encourage or discourage the market for mortgage loans as an investment.

Supply and demand for money

Money is a limited commodity subject to the effects of supply and demand. The federal government's monetary policy *controls the supply of money* in order to achieve the country's economic goals. An excessive supply of money usually causes interest rates to fall and consumer prices to rise. Conversely, an excessive demand for money, such as for mortgage loans, causes interest rates to rise and prices to fall. Regulation of the money supply addresses these fluctuations with the aim to control and limit wide swings in the supply and demand cycle. These efforts, in turn, help to buffer the economy from severe inflationary or recessionary trends.

Regulating the money supply. The Federal Reserve System regulates the money supply by means of three methods:

- ▶ *selling or re-purchasing government securities*, primarily Treasury bills
- ▶ changing the *reserve requirement* for member banks. The reserve is a percentage of depositors' funds that banks and other regulated financial institutions may not lend out.
- ▶ changing the interest rate, or *discount rate*, the system charges member institutions for borrowing funds from the Federal Reserve System central banks

When the Federal Reserve sells Treasury bills, the money paid for the securities is removed from the economy's money supply. Conversely, when it repurchases Treasury bills, the cash paid out to investors puts money back into the economy.

The second control, regulating reserve requirements, effectively restricts how much money banks can put into the economy through the disbursement of loans. When the Federal Reserve *raises* reserve requirements, banks have less money to lend, decreasing the money supply. When the Fed *lowers* reserve requirements, banks have more money to lend, increasing the money supply.

The third control, and perhaps the most effective, is regulation of the discount rate which member banks must pay to borrow money. If the discount rate goes up, it becomes more cost-prohibitive to borrow. Therefore the money supply tightens. If the discount rate is lowered, banks have an incentive to borrow more money to lend to customers.

The primary mortgage market

The **primary mortgage market** consists of lenders who originate mortgage loans directly to borrowers. Primary mortgage market lenders include:

- ▶ savings and loans
- ▶ commercial banks
- ▶ mutual savings banks

- ▶ life insurance companies
- ▶ mortgage bankers
- ▶ credit unions

Mortgage brokers are also part of the primary mortgage market, even though they do not lend to customers directly. Rather, they are instrumental in procuring borrowers for primary mortgage lenders.

The primary lender assumes the initial risk of the long-term investment in the mortgage loan. Primary lenders sometimes also **service** the loan until it is paid off. Servicing loans entails collecting the borrower's periodic payments, maintaining and disbursing funds in escrow accounts for taxes and insurance, supervising the borrower's performance, and releasing the mortgage on repayment. In many cases, primary lenders employ mortgage servicing companies, which service loans for a fee.

Portfolio lenders. A primary mortgage market lender may or may not sell its loans into the secondary market. Many lenders originate loans for the purpose of retaining the investments in their own loan *portfolio*. These loans are referred to as *portfolio loans*, and lenders originating loans for their own portfolio are called *portfolio lenders*. Portfolio lenders are less restricted by the standards and forms imposed on other lenders by secondary market organizations. In retaining their portfolio loans, portfolio lenders may vary underwriting criteria and hold independent standards for down payment requirements and the condition of the collateral.

The secondary mortgage market

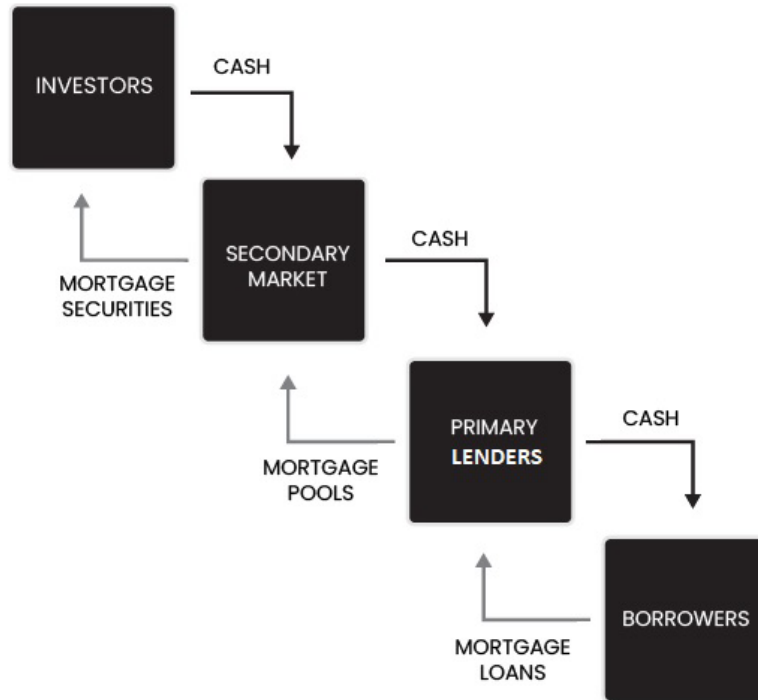
Lenders, investors and government agencies that buy loans already originated by someone else, or originate loans indirectly through someone else, constitute the **secondary mortgage market**.

Secondary mortgage market organizations include:

- ▶ Federal National Mortgage Association (FNMA, or Fannie Mae)
- ▶ Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac)
- ▶ Government National Mortgage Association (GNMA, or Ginnie Mae)
- ▶ investment firms that assemble loans into packages and sell securities based on the pooled mortgages
- ▶ life insurance companies
- ▶ pension funds
- ▶ primary market institutions who also invest as secondary lenders

Secondary mortgage market organizations buy pools of mortgages from primary lenders and sell securities backed by these pooled mortgages to investors. By selling securities, the secondary market brings investor money into the mortgage market. By purchasing loans from primary lenders, the secondary market returns funds to the primary lenders, thereby enabling the primary lender to originate more mortgage loans.

Exhibit 17.4 Money Flow in the Mortgage Market



Primary lenders make a profit on the sale of loans to the secondary market. The secondary market acquires a profitable long-term investment without having to underwrite, originate, and service the loans. Secondary market organizations customarily hire primary lenders or loan servicing companies to service mortgage pools.

Secondary market loan requirements. The secondary market only buys loans that meet established requirements for quality of collateral, borrower and documentation. Since many primary lenders intend to sell their loans to the secondary market, the qualification standards of the secondary market limit and effectively regulate the kind of loans the primary lender will originate.

Role of FNMA GNMA, FHLMC AND FAMC

As major players in the secondary market, the Federal National Mortgage Association (FNMA, "Fannie Mae"), Government National Mortgage Association (GNMA, "Ginnie Mae"), Federal Home Loan Mortgage Corporation (FHLMC, "Freddie Mac") and Federal Agricultural Mortgage Corporation (FAMC, "Farmer Mac") tend to set the standards for the primary market.

Federal National Mortgage Association, or Fannie Mae. Fannie Mae is a government-sponsored enterprise, originally organized as a privately-owned corporation. As a secondary market player, it:

- ▶ buys conventional, FHA-backed and VA-backed loans
- ▶ gives banks mortgage-backed securities in exchange for blocks of mortgages

- ▶ offers lenders firm loan purchase commitments, provided they conform to Fannie Mae's lending standards
- ▶ sells bonds and mortgage-backed securities
- ▶ guarantees payment of interest and principal on mortgage-backed securities

Government National Mortgage Association, or Ginnie Mae. Ginnie Mae is a division of the Department of Housing and Urban Development. Its purpose is to administer special assistance programs and to help Fannie Mae in its secondary market activities. Specifically, GNMA

- ▶ guarantees payment on FNMA high-risk, low-yield mortgages and absorbs the difference in yield between the mortgages and market rates
- ▶ guarantees privately generated securities backed by pools of VA-and FHA-guaranteed loans

Federal Home Loan Mortgage Corporation, or Freddie Mac. Freddie Mac is a government-sponsored enterprise, originally chartered as an corporation in 1970. As a secondary market player, FHLMC buys mortgages and pools them, selling bonds backed by the mortgages in the open market. Freddie Mac guarantees performance on FHLMC mortgages.

A federal conservator, the Federal Housing Finance Authority (FHFA), now operates Fannie Mae and Freddie Mac as conservator with the U.S. Treasury a majority owner of both organizations.

The Federal Agricultural Mortgage Corporation, or Farmer Mac. Farmer Mac (FAMC) is a federal agency whose central function is to increase the availability and affordability of credit for American agriculture and American rural communities. In effect, Farmer Mac is the secondary loan market for American agricultural businesses. More specifically, Farmer Mac provides rural lenders and cooperatives with liquidity and lower-cost capital for funding agricultural assets, businesses and other related capital requirements within the farming community.

Farmer Mac's central activities within the agricultural credit market include purchasing ag loans; enhancing USDA loan guarantees; providing credit guarantees for loans and credit; and providing flexible, wholesale credit for ag lenders, agribusinesses, and applicable investment firms.

TYPES OF REAL ESTATE LOANS

Conventional loans
FHA-insured loans
VA-guaranteed loans
Common loan structures
Seller financing
Special-purpose loans

Conventional loans A **conventional mortgage** loan is a permanent long-term loan that is not FHA-insured or VA-guaranteed. Market rates usually determine the interest rate on the loan. Because of the lack of insurance or guarantee by a government agency, the risk to a lender is greater for a conventional loan than for a non-conventional loan. This risk is usually reflected in higher interest rates and stricter requirements for the down payment and the borrower's income qualification. At the same time, conventional loans allow greater flexibility in fees, rates, and terms than do insured and guaranteed loans.

The primary sources of conventional loans are banks and savings and loan associations. Other conventional lenders include credit unions, life insurance companies, pension funds, mortgage bankers, and private individuals. Various types of lenders specialize in mortgage lending for specific purposes and type of borrower, such as commercial, construction, or single-family residential loans.

FHA-insured loans The Federal Housing Administration (FHA) is an agency of the Department of Housing and Urban Development (HUD). It does not lend money, but *insures* permanent long-term loans made by others. The lender must be approved by the FHA, and the borrower must meet certain FHA qualifications. In addition, the property used to secure the loan must meet FHA standards. The FHA insures that the lender will not suffer significant loss in the case of borrower default. To provide this security, FHA provides insurance and charges the borrower an insurance premium. FHA loans typically have a higher loan-to-value ratio than conventional loans, enabling a borrower to make a smaller down payment. The basic FHA-insured loan program is the **Title II, Section 203(b)** program for loans on one- to four-family residential properties. Among the features of this program are the following.

FHA mortgage insurance. The FHA determines how much mortgage insurance must be provided and charges the borrower an appropriate mortgage insurance premium (MIP). The initial premium is payable at closing or is added to the borrower's loan balance and financed. Further annual premiums are charged monthly. The amount of the premium varies according to the loan term and the applicable loan-to-value ratio.

Borrower default. The FHA reimburses the lender for losses due to default by the borrower, including costs of foreclosure.

Appraisal. The property must be appraised by an FHA-approved appraiser. The property must also meet the FHA's standards for type and quality of construction, neighborhood quality, and other features.

Maximum loan amount. The FHA has set maximum loan amounts for over 80 regions. Borrowers within a region are limited to the loan ceiling amount in effect for the region. In addition, the maximum loan amount is restricted by the loan-to-value ratios in effect. The maximum FHA-backed loan a borrower can obtain will be the lesser of the regional ceiling amount or the amount dictated by the loan-to-value standard. Calculations are based on the lesser of sale price or appraised value.

Down payment requirement. The minimum down payment for an FHA-backed loan is based on the lower of the appraised value or the sales price. The present requirement for single-family residential loans is 3.5%.

Maximum loan term. Thirty years is the maximum length of the repayment period.

Prepayment privilege. The borrower has the right to pay off the loan at any time without penalty, provided the lender is given prior notice. The lender may charge up to 30 days' interest if the borrower provides less than 30 days' notice.

Assumability. FHA-backed loans on owner-occupied properties are assumable if the buyer is qualified. Lenders and borrowers should check with FHA for current requirements.

Interest rate. The lender and borrower negotiate the interest rate on an FHA-backed loan without any involvement by FHA.

Points, fees and costs. The lender may charge discount points, a loan origination fee, and other such charges. These may be paid by buyer or seller. However, if the seller pays more than a specified percentage of the costs normally paid by a buyer, the FHA may regard these as sales concessions and lower the sales price on which the loan insurance amount is based.

In addition to Section 203(b) loan programs, FHA offers insurance coverage for other loan products. These include:

- ▶ home improvement loans
- ▶ subsidized loans for low- and middle-income families
- ▶ loans for condominiums
- ▶ loans for multi-family projects
- ▶ graduated-payment loans
- ▶ adjustable-rate loans

VA-guaranteed loans

The Department of Veterans Affairs (formerly Veterans Administration) offers *loan guarantees to qualified veterans*. The VA, like the FHA, does not lend money except in certain areas where other financing is not generally available. Instead, the VA partially guarantees permanent long-term loans originated by VA-approved lenders on properties that meet VA standards. The VA's guarantee enables lenders to issue loans with higher loan-to-value ratios than would otherwise be possible. The interest rate on a VA-guaranteed loan is usually lower than one on a conventional loan. The borrower does not pay any premium for the loan guarantee, but does pay a VA funding fee at closing.

Borrower default. The VA reimburses the lender for losses up to the guaranteed amount if foreclosure sale proceeds fail to cover the loan balance.

Appraisal. The property must be appraised by a VA-approved appraiser. The VA issues a *Certificate of Reasonable Value* which creates a maximum value on which the VA-guaranteed portion of the loan will be based. The property must meet certain VA specifications.

Down payment requirement. The VA usually requires no down payment, although the lender may require one.

Maximum loan amount. The VA does not cap the loan amount, but it does limit the liability it can assume, which usually influences the amount an institution will lend. The amount a qualified veteran with full entitlement can borrow without making a downpayment determines the practical loan limits. This amount varies by county. The basic entitlement available to each eligible veteran is \$36,000. Lenders will generally lend a maximum of 4 times that amount without a down payment if the veteran is fully qualified and the property appraises for the asking price.

A veteran must apply for a *Certificate of Eligibility* to find out how much the VA will guarantee in a particular situation.

Maximum loan term. The maximum loan term for one- to four-family residences is 30 years. For loans secured by farms, the maximum loan term is 40 years.

Prepayment privilege. The loan may be paid off early without penalty.

Assumability. VA loans are assumable with lender approval. Usually, the person assuming the loan must have VA eligibility, and the assumption may have to be approved by the VA.

Interest rate. Lender and borrower negotiate the interest rate for all VA-insured loans.

Points, fees and costs. The lender may charge discount points, origination fees, and other reasonable costs. These may be paid by seller (with some limits) or buyer, but may not be financed. The VA funding fee, however, may be included in the loan amount. The funding fee is a percentage of the loan amount which varies based on the type of loan, military category, whether the loan is a first-time loan, and whether there is a down payment.

Other VA programs. In addition to insuring loans to veterans, the VA may insure loans for lenders who set up a special account with the VA. The VA may also actually lend money directly when an eligible veteran cannot find other mortgage money locally.

Common loan structures

Variations in the structure of interest rate, term, payments, and principal payback produce a number of commonly recognized loan types. Among these are the following.

Amortizing loan. Amortization provides for gradual repayment of principal and payment of interest over the term of the loan. The borrower's periodic payments to the lender include a portion for interest and a portion for principal. In a fully amortizing mortgage, the principal balance is zero at the end of the term. In a

partially amortizing loan, the payments are not sufficient to retire the debt. At the end of the loan term, there is still a principal balance to be paid off.

Negatively amortized loan. Negative amortization causes the loan balance to increase over the term. This occurs if the borrower's periodic payment is insufficient to cover the interest owed for the period. The lender adds the amount of unpaid interest to the borrower's loan balance. Temporary negative amortization occurs on graduated payment loans, and may occur on an adjustable rate mortgage.

Adjustable and fixed rate loans. Loans may have fixed or variable rates of interest over the loan term. Adjustable rate mortgages (ARMs) allow the lender to change the interest rate at specified intervals and by a specified amount. Federal regulations place limits, called rate caps, on incremental interest rate increases and on the total amount by which the rate may be increased over the loan term.

Senior and junior loans. When there are multiple loans on a single property, there is an order of priority in the liens which the mortgages create. The first, or senior, loan generally has priority over any subsequent loans. Second loans are riskier than first loans because the senior lender will be satisfied first in case of default. Therefore, interest rates on second mortgages are generally higher than on first mortgages.

Fixed and graduated payment loans. Loans may have variable payment amounts over the term of the loan, or a single fixed payment amount. With a graduated payment mortgage, the payments at the beginning of the loan term are not sufficient to amortize the loan fully, and unpaid interest is added to the principal balance. Payments are later adjusted to a level that will fully amortize the loan's increased balance over the remaining loan term.

Interest-only loan. In an interest-only loan, periodic payments over the loan term apply only to interest owed, not to principal. At the end of the term, the full balance must be paid off in a lump-sum, "balloon" payment. Since these loans have no periodic principal payback, their monthly payments are smaller than amortizing loans for the same amount at the same rate of interest.

Buydown loan. A buydown loan entails a prepayment of interest on a loan. The prepayment effectively lowers the interest rate and the periodic payments for the borrower. Buydowns typically occur in a circumstance where a builder wants to market a new development to a buyer who cannot quite qualify for the necessary loan at market rates. By "buying down" a borrower's mortgage, a builder enables the borrower to obtain the loan. The builder may then pass the costs of the buydown through to the buyer in the form of a higher purchase price.

Seller financing

The seller may provide some or all of the financing for the buyer's purchase. Some of the most common methods of seller financing are purchase money mortgages, including the wraparound, and the contract for deed.

Purchase money mortgage. With a purchase money mortgage, the borrower gives a mortgage and note to the seller to finance some or all of the purchase price of the property. The seller in this case is said to "take back" a note, or to

"carry paper," on the property. Purchase money mortgages may be either senior or junior liens.

Wraparound. In a wraparound loan arrangement, the seller receives a junior mortgage from the buyer, and uses the buyer's payments to make the payments on the original first mortgage. A wraparound enables the buyer to obtain financing with a minimum cash investment. It also potentially enables the seller to profit from any difference between a lower interest rate on the senior loan and a higher rate on the wraparound loan. A wraparound is possible only if the senior mortgagee allows it.

Contract for deed. Under a contract for deed arrangement, the seller retains title and the buyer receives possession and equitable title while making payments under the terms of the contract. The seller conveys title when the contract has been fully performed.

Special-purpose loans

Home equity loan. The ostensible purpose of this type of loan is to obtain funds for home improvement. Structurally, the home equity loan is a junior mortgage secured by the homeowner's equity, **equity** in general being the portion of the property's value actually owned by the homeowner, expressed as the difference between the property's market value and all loan balances outstanding on the property.

For some lenders, the maximum home equity loan amount is based on the difference between the property's appraised value and the maximum loan-to-value ratio the lender allows on the property, inclusive of all existing mortgage loans. Thus if a home is appraised at \$500,000 and the lender's maximum LTV is 80%, the lender will lend a total of \$400,000. If the owner's existing mortgage balance is \$325,000, the owner would qualify for a \$75,000 home equity loan.

Package loan. A package loan finances the purchase of real estate and personal property. For example, a package loan might finance a furnished condominium, complete with all fixtures and decor.

Construction loan. A construction loan finances construction of improvements. This type of loan is paid out by the lender in installments linked to stages of the construction process. The loan is usually interest-only, and the borrower makes periodic payments based on the amount disbursed so far. As short-term, high-risk financing, the interest rates are usually higher than those for long-term financing. The borrower is expected to find permanent ("take out") financing elsewhere to pay off the temporary loan when construction is complete.

Bridge loan. A bridge, or gap, loan is used to cover a gap in financing between short-term construction financing and long-term permanent financing. For instance, a developer may have difficulty finding a long-term lender to take out the construction lender. However, as the construction loan is expensive and must be paid off as soon as possible, the developer may find an interim lender who will pay off the construction loan but not agree to a long-term loan.

Participation loan. In a participation loan, the lender participates in the income and/or equity of the property, in return for giving the borrower more favorable loan terms than would otherwise be justified. For instance, the borrower makes

smaller periodic payments than the interest rate and loan amount require, and the lender makes up the difference by receiving some of the property's income. This type of loan usually involves an income property.

Permanent (take-out) loan. A permanent loan is a long-term loan that "takes out" a construction or short-term lender. The long-term lender pays off the balance on the construction loan when the project is completed, leaving the borrower with a long-term loan under more favorable terms than the construction loan offered.

Reverse annuity. In a reverse annuity mortgage, a homeowner pledges the equity in the home as security for a loan which is paid out in regular monthly amounts over the term of the loan. The homeowner, in effect, is able to convert the equity to cash without losing ownership and possession.

Blanket. A blanket mortgage is secured by more than one property, such as multiple parcels of real estate in a development.

For more information:

FHA loans:	https://entp.hud.gov/idapp/html/hicostlook.cfm
VA loans:	https://www.va.gov/housing-assistance/
HUD:	https://www.hud.gov/resources
FNMA:	http://www.fanniemae.com/portal/index.html
FHLMC:	www.freddiemac.com
GNMA:	https://www.ginniemae.gov/pages/default.aspx
FAMC	https://www.farmermac.com/
ECOA:	https://www.consumer.ftc.gov/articles/0347-your-equal-credit-opportunity-rights
CFPB:	https://www.consumerfinance.gov/policy-compliance/guidance/tila-respa-disclosure-rule/

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Real Estate Finance Snapshot Review

ANATOMY OF MORTGAGE LENDING

Mechanics of a loan transaction

- mortgage financing: using borrowed money secured by a mortgage to finance the purchase of real estate
- instruments: note and mortgage or trust deed
- mortgage mechanics: borrower gives lender note and mortgage; lender gives borrower funds and records a lien
- trust deed mechanics: trust deed conveys title from the borrower/trustor to a third-party trustee who holds title on behalf of the lender/beneficiary until the debt is repaid

Financial components of a loan

- original principal: capital amount borrowed on which interest payments are calculated
- loan balance: remaining unpaid principal at any point in the life of the loan
- interest: charge for the use of money; rate fixed or variable
- Annual Percentage Rate (APR) includes interest and all other finance charges; lender must disclose on residential properties
- point: one percent of the loan amount, charged by lender at origination to obtain required return
- term: period of time for repayment of interest and principal
- payment: the periodic payment of interest and/or principal

Promissory note

- legal instrument executed by borrower stating debt amount, loan term, method and timing of repayment, interest rate, promise to pay; may repeat other provisions from mortgage document or deed of trust; negotiable instrument assignable to a third party

Mortgage document and trust deed

- the legal documents which pledge the property as collateral for the loan
- may include clauses covering payment of principal and interest, prepayment, late charges, escrow for taxes and insurance, liens, insurance requirements, occupancy and maintenance, lender's rights, private mortgage insurance, inspection, and other conditions of performance

INITIATING A MORTGAGE LOAN

The loan application

- borrower provides personal and property data; supporting documentation: appraisal report, credit report, purchase contract, income and/or employment verification
- lenders must accept all completed applications and notify applicants about disposition of application

Mortgage loan underwriting

- process of evaluating borrower's ability to repay and value of the property
- loan-to-value ratio: relationship of loan amount to property value, expressed as a percentage

QUALIFYING FOR A MORTGAGE LOAN

Equal Credit Opportunity Act

- lender must evaluate applicant according to applicant's own income and credit information

Income qualification

- income ratio and debt ratio qualify borrower's income; income ratio applied to gross income determines housing expense maximum; debt ratio takes revolving debt into account

Loan constant

- monthly or annual payment amount needed to amortize a \$1,000 loan given interest rate and term; used to derive loan amount or payment amount with known interest rate and loan term

Cash qualification

- lender verifies applicant's sources of cash for down payment; extra cash enhances income qualification evaluation

Net worth

- extent to which applicant's assets exceed liabilities as a further source of reserves

Credit evaluation

- lender obtains credit reports to evaluate applicant's payment behavior

Loan commitment

- written pledge by lender to grant loan under specific terms; firm, lock-in, conditional, take-out

CLOSING A LOAN

- usually simultaneous with closing of real estate transaction; transfer of funds, signing of documents, escrow deposits

LAWS AFFECTING MORTGAGE LENDING

Truth-in-Lending and Regulation Z

- Reg Z implements Truth-in-Lending Simplification and Reform Act and Consumer Credit Protection Act
- provisions: lender must disclose finance charges and APR prior to closing; borrower has limited right of rescission; lender must follow disclosure requirements in advertising

Equal Credit Opportunity Act

- ECOA prohibits discrimination in lending

Real Estate Settlements and Procedures Act

- RESPA standardizes settlement practices
- provisions: lender must provide CFPB booklet explaining loans, settlement costs and procedures; lender must provide CFPB Loan Estimate of settlement costs within three days of application; lender must provide CFPB Closing Disclosure three days before loan consummation

National Flood Insurance Act

- borrowers of "federally-related loans" must obtain flood insurance if property is in designated flood-hazard area

THE MORTGAGE MARKET

Supply and demand for money

- relationship between money supply and demand affects interest rates, consumer prices, availability of mortgage money
- Federal Reserve controls: T-bills; reserve requirement, discount rate

The primary mortgage market

- originates mortgage loans directly to borrowers; savings and loans, commercial banks, mutual savings banks, life insurance companies, mortgage bankers, credit unions

The secondary mortgage market

- buys existing loans to provide liquidity to primary lenders; Fannie Mae, Ginnie Mae, Freddie Mac, investment firms, life insurance companies, pension funds

Role of FNMA, GNMA, FHLMC, and FAMC

- FNMA buys conventional, FHA- and VA-backed loans and pooled mortgages; guarantees payment on mortgage-backed securities; GNMA guarantees payment on certain types of loans; FHLMC buys and pools mortgages; sells mortgage-backed securities; FAMC funds agricultural assets, businesses and related capital requirements for the farming community

TYPES OF REAL ESTATE LOANS**Conventional loans**

- permanent, long-term loans not insured by FHA or guaranteed by VA

FHA-insured loans

- insured loans granted by FHA-approved lenders to borrowers who meet FHA qualifications

VA-guaranteed loans

- guaranteed loans granted by VA-approved lenders to qualified veterans

Common loan structures

- amortizing, negative amortizing, interest only, fixed rate, adjustable rate, senior, junior, fixed or graduated payment, balloon, buydown

Seller financing

- purchase money mortgages: loans by the seller to the property buyer for all or part of the purchase price; contract for deed: installment sale where seller finances buyer and retains title until contract terms are met

Special-purpose loans

- home equity, package, construction, bridge, equity participation, take-out, reverse annuity, and blanket