REAL ESTATE FINANCE

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Real Estate agents are urged to refer to two indispensable reference sources: **"Real Estate law"** and **"Real Estate Reference Book"** published by California Department of Real Estate. Please visit DRE's web-site, ☞ ***www.dre.ca.gov .*** Or you may order via our school.

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PREFACE

A career in real estate finance can be exciting and profitable if a person is self–motivated and with the skills and tools needed. This book is intended for those who seek to gain knowledge as a real estate licensee, for individuals to enter the real estate finance business and also for persons already actively working in the industry.

Real estate is expensive, and few people ever accumulate enough savings to pay for it with all cash. Most real estate transactions hinge, therefore, on the buyer's ability to obtain financing. Even people who have sufficient funds rarely pay cash for real estate because (as noted in a later chapter) income tax deductions and investment yields favor purchasing real estate with borrowed funds, called **"**leverage**"**. Thus, whether by necessity or by choice, financing is essential for most real estate transactions.

Real Estate Finance is an introduction to the many interesting aspects of the real estate business. This book has been written primarily for the prospective real estate broker or sales–person, but it will also be of interest to the people who wants to become a real estate professional.

HOW TO USE THIS BOOK

Read the text of each chapter. At the end of each chapter there are chapter quiz that will require you to use what you have learned to solve problems involving practical applications of the topics covered. After you complete a test, you can check the answer key provided.

It is difficult to overestimate the growing importance of the Internet to the real estate industry. The resources available there have brought together the interests of agents, consumers and investors. Throughout this book you will find addresses on the World Wide Web, a collection of computer sites referred to in this book as the ☞ **web**.

The web has made the Internet easily accessible to anyone with a computer and modem or, in some cases, a television set coupled with a phone line and wireless keyboard. There are web sites sponsored by government agencies, sites run by private trade groups and others that are commercial enterprises yet offer a great deal of free information that is both interesting and useful.

We encourage you to explore the sites mentioned in this book to expand on what you read here. To make it easy to find site references, they are highlighted in the margins of the text. There is also a complete list of all site references in the Internet Appendix at the back of the book. As with any resource, you are cautioned to use good judgment when considering the validity of the information you find on the Internet.

Read the text of each chapter, at the end of each chapter are chapter test that will require you to use what you have learned to solve problems involving practical applications of the topics covered. After you complete a test, you can check the answer key by looking at the back of the book.

Following additional education materials are included in your CDs:

☞1. Appendix B: Consumer Handbook on Adjustable Rate Mortgage, published by Federal Reserve Board, Office of Thrift Supervision. (27 pages).

☞2. Appendix C: Homebuyer's Guide, Published by HUD. (140 pages).

Research and written by Joseph Lee, Ph. D. in Economics.

DISCLAIMER

"This course is approved for basic education credit by the California Department of Real Estate. However, this approval does not constitute an endorsement of the views or opinions which are expressed by the course sponsor, instructor, authors or lectures."

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CHAPTER 1: IMPORTANCE OF REAL ESTATE FINANCE

PREVIEW

Real estate finance is the allocation of funds in large quantities to borrowers who wish to acquire or develop real property. **Financing** is the process by which money is borrowed and allocated in a specific real estate project, such as obtaining a purchase money loan, or refinancing to obtain more favorable terms, or taking equity out of a property for other uses.

A study of real estate finance must look at money from several points of view – the role of money in the economy, the sources of money for loans, the position of real estate principals and agents in competing for available money, and the processes of negotiating and setting up those loans.

Finance is of paramount importance to the real estate industry, for without the availability of money to reach effective levels of real estate sales and development, significant real estate activity ceases. Since both land and construction are expensive, substantial sums of money are required for financing. These sums may be committed for a long period of time to permit a gradual repayment of principal borrowed. The money borrowed is secured primarily by the real property being financed.

HISTORY OF FINANCING

LAND – THE UNDERLYING BASIS OF WEALTH

Real estate in the form of land and improvements comprises a substantial amount of the total net worth of the United States. In addition, the real estate industry is a major employer, providing billions of dollars in income for millions of American workers and investors. When mortgage funds are scarce, real estate activity and employment decline, and a general hardship is felt throughout the economy.

FINANCING PRIOR TO THE 1930S

Sophisticated methods have developed for translating land's value into market transactions. But until well into this century, financing was not highly developed or systematized.

FINANCING SINCE THE 1930S

The Great Depression promoted monumental changes in financing. As the depression caused massive foreclosures and a huge devaluation of real property, there emerged the first in–depth research into land use, real estate valuation, and the financing of real property in this country.

GOVERNMENT PARTICIPATION

The federal government entered into real estate financing for the first time by establishing the:

- **FEDERAL HOUSING ADMINISTRATION** (FHA, 1934) – The long–term amortized loan developed by FHA brought about a profound change in home and farm financing.
- **Federal Home Loan Bank Board** (FHLBB, 1932) – The credit reserve system of the FHLBB added to the stability of the savings and loan industry.

- **Federal Deposit Insurance Corporation** (FDIC, 1934) – The federal insurance of deposits in commercial banks ended the banking crisis of the Great Depression by restoring the public's confidence in banks and bringing to an end the "run on the bank" which could destroy a bank. Banks still sometimes fail, but since the establishment of the HDIC, no depositor has ever lost money in an FDIC–insured account. Very few people today fear the safety of funds in commercial banks.

- **Federal Savings and Loan Insurance Corporation** (FSLIC, 1934) – The federal insurance of deposits in savings and loan associations restored public confidence in the S&L industry.

- **Federal National Mortgage Association** (FNMA, 1938) – The secondary mortgage money market created by FNMA stimulated the primary mortgage money market by giving lenders their first organized system for selling existing loans and making money available for more loans in more areas. Through "Fannie Mae" the federal government laid the foundation for the modern secondary mortgage money market.

- **Government National Mortgage Association** (GNMA) – "Ginnie Mae" assumed some of Fannie Mae's riskier functions in 1968 when Fannie Mae was converted to a stockholder–owned corporation.

- **Professional Standards** – The real estate industry began long strides toward professionalization, especially in the areas of property valuation and management. Lenders began demanding professional management of properties they acquired through foreclosures and defaults.

Housing Cycles

Unfortunately, the housing cycle is irregular and wild, with great booms followed by falls. Several "boom times" in real estate occurred in the early 1960s, 1971–1973, 1975–1979, 1982–89, and the late 1990s and early 2000-2002s. However, between these periods were some bad years–1966, 1969, 1974, 1980–1981, and a severe housing crash from 1990 to 1996 in many parts of California.

What causes a bust in the real estate market? Things such as high interest rates, government deficits, and better investment opportunities can cause what is known as ***disintermediation,*** which is the sudden flow of funds out of thrift institutions (which grant real estate loans) into the general money market (where real estate loans are not common). This drying up of real estate funds raises havoc in the housing market. In short, real estate activity is directly tied to the availability and cost of mortgage funds and to the general state of the economy. As these two items shift up and down, so goes the real estate market.

Therefore, an agent's or an investor's success in real estate partially depends on a thorough understanding of trends in the mortgage market. The remainder of this book is devoted to an explanation of real estate finance, including the wide range of creative and alternative financing techniques used in buying and selling real estate.

Recent Developments

Changes in the real estate market beginning in the 1970's and continuing into the 2000's have prompted an increasingly businesslike approach to financing.

- **Appraisal** – Appraisal techniques for property valuation have become exceedingly sophisticated.
- **Alternative Financing** – An increasing number of more flexible and creative methods have evolved to provide ways of financing real estate.
- **Long–Term Amortized Loan** – The traditional fixed–rate long–term (25–30 year) amortized loan has become less prevalent because of fluctuating interest rates and periods of tight money markets.

  Generally, the 25 to 30 year loan in which the principal and interest are paid in full by a series of equal or nearly equal periodic payments has become the standard since the advent of FHA.

  Since the period of extremely high interest rates in 1981–82, some lenders have offered 40–year loans to enable some additional prospective buyers to qualify for financing because of the lower monthly payment required for 40 year amortization compared with 30–year amortization. However, not much is gained by this technique, and the cost can be significant.

ARM – Since 1979 the adjustable rate mortgage and mortgages with balloon payment provisions have become commonplace.

Real estate debt in the last few decades has increased significantly.

- **Tax Structure** – Income taxation has dramatically affected real estate as an attractive investment.

☞ ***Example:***

A $100,000 loan at an interest rate of 10% can be compared at 30 years vs. 40 years

Term	*Monthly Payment*	*Total Interest Full Term*	*Total Interest Paid In First 5 years*
30 years	*$877.58*	*$215,926*	*$49,228*
40 years	*$849.15*	*$307,590*	*$49,724*
Difference	*$28.43*	*$91,664*	*$496*

For the homebuyer who does not expect to own the home very long the $28.43 monthly reduction in principal and interest payment could be the difference between qualifying and not qualifying, and could be well worth the additional interest over the short term.

THE 1989 S&L BAILOUT

- **Background** – Following “deregulation” of the savings and loan industry, beginning in 1980, many S&Ls began aggressive expansion into riskier investments, opening the doors to the excesses of greed and fraud. By 1989 there were so many insolvent and financially shaky thrift institutions that one Congressman described the situation as the “greatest financial scandal” in our nation's history.

- **Insanity Factor** – S&Ls on the brink of failure would offer home loans at unrealistically low rates to attract business. At the same time they would pay higher than normal interest rates to depositors to attract cash at a time when many depositors were withdrawing cash because of the fear of financial unsoundness. Meanwhile, financially healthy institutions were having to compete with the lower mortgage rates and higher deposit rates, cutting deeply into profits. One economist described such unsound business practices as the “insanity factor.”

- **Federal Losses** – The sick thrifts had little to lose if they failed; the federal government would take over and pay each depositor up to the $100,000 insured limit. By the time the federal S&L bailout bill was passed in 1989, it was estimated that the losses suffered by the government on federally insured deposits were $20 million to $30 million each day.

- **The Rescue** – In 1989, Congress enacted, and the President signed, the $159 billion financial rescue, the largest in the nation's history. The total costs are projected to be as high as $335 billion over the following 30 years.

- **Close Insolvent Thrifts** – Regulators are empowered to close an estimated 500 insolvent thrifts and pay off depositors. Many thrifts will be liquidated; many others will be sold to healthy institutions.

- **Financing the Bailout** – The financing of the bailout over the next 30 years involves:

    - Higher annual FSLIC insurance premiums charged S&Ls and banks

    - Moratorium on healthy S&Ls leaving FSLIC for FDIC to avoid higher rates

    - Sale of U.S. Treasury bonds

    - Creation of the Resolution Trust Corporation to take over and sell assets of failed thrifts

    - Allocation of earnings of the FHLB

    - Requiring taxpayers to pay through new taxes, a shift in budget expenses, additions to the federal deficit, or some combination of these measures.

- **Fighting Fraud** – Several provisions are included in the new law to strengthen the government's power to fight fraud, including expanded authority for seizing property of civil and criminal wrongdoers, and other stiffer penalties against "white–collar" criminals.

- **Stronger Regulation** – The law creates a new Office of Thrift Supervision to regulate state–chartered thrifts. Specific regulations include:

    - The Resolution Trust Corporation (RTC) is created to take over approximately $100 billion worth of real property from insolvent S&Ls–to sell at the best price.

- Thrifts must raise capital to at least three percent of assets by 1990, and S&Ls that fall below the minimum capital ratio are severely restricted in their activities.

- Federal regulators may override state regulations that allow S&Ls to make nonmortgage–related investments such as speculative real estate deals.

- Regulators can impose civil penalties up to $1 million a day on thrifts that defy orders to stop unsound practices.

◆ **Consumer Provisions** – The S&L rescue legislation has a series of provisions aimed at providing financing for moderate–income first–time homebuyers and lower–income renters, as well as general provisions to make home mortgage money more available.

- S&Ls are now required to have at least 70% of their assets in housing related activities. This requires S&Ls to channel more of their lending to home mortgages and away from speculative commercial real estate ventures and high–yield, high–risk junk bonds.

- S&Ls are required to establish programs to finance low–income and moderate–income housing.

- Government agencies are required to use residential properties from liquidated S&Ls to provide housing for low – and moderate–income families through various programs of low–cost financing.

THE IMPORTANCE OF FINANCE TO REAL ESTATE

Few individuals or firms are able to pay cash to purchase or develop real property. Those who are able generally prefer to finance their purchases in order to gain tax benefits and utilize leverage. The difference between success and failure in real estate is often determined by the ability to understand and apply financing to best advantage in each transaction.

REAL ESTATE FINANCE

Of all the aspects of real estate, finance is the most important after the land and buildings themselves. Without the availability of money and credit, there would be no real estate market – no real estate industry. Very few prospective buyers would be able to buy; very few prospective sellers would be able to sell.

DEVELOPMENT

Financing makes the projects of contractors and developers possible.

- Construction financing (a short–term loan to provide funds for construction) is necessary during interim building periods.
- Take–out financing (a long–term loan to take the construction lender out of the picture) is necessary upon project completion.

REAL ESTATE BROKERAGE

Financing makes sales possible for new and existing properties.

- The price of a property is influenced by the financing available, which affects the down-payment amount and the number of buyers capable of qualifying for loans.
- Many buyers **"**shop**"** financing terms even more than sale price. Their ability to purchase depends primarily on their ability to afford the monthly loan payments.

PROPERTY MANAGEMENT

Financing is one of the major variables a property manager considers in optimizing the income from a property.

- Availability of financing is a key factor in determining the value of income property to an investor.
- The total cost of a property, including debt services, is the primary consideration in establishing the rent schedule necessary to produce a cash flow for the owner.

1. IMPORTANCE OF REAL ESTATE FINANCE

THE PUBLIC

- **Home Buyers** – Purchasing a home is the major investment for most families, and a cash purchase is generally impossible. When property values rise, the availability of financing determines, more and more, whether or not the

- **Investors** – Frequently, income property is purchased to take advantage of leverage. **Leverage** is using others money to the maximum extent. Without financing, leverage is not possible.

- **Refinancing** – The public provides an enormous demand for money through refinancing.

GOVERNMENT INVOLVEMENT

Governments exert an enormous influence on finance at different levels. The controls increasingly affect the cost and availability of funds for real property.

- **Regulations** – Regulations on interest and loan broker commission rates directly affect how much the borrower pays for money.

- **Monetary and Fiscal Policies** – Government spending, tax policies, and regulation of the money supply all affect the availability of mortgage money, and the prevailing interest rates.

- **Land Use** – Local controls on growth and density, and environmental restrictions on uses of property, affect the cost of developing real estate, the demand for real estate, and the willingness of lenders to finance.

- **Infrastructure** – Availability and costs of utilities, transportation, etc., affect the cost and the desirability of property for both buyers and lenders.

THE IMPORTANCE OF FINANCING TO THE REAL ESTATE LICENSEE

To be successful, real estate licensees need a working knowledge of real property financing. One of their main tasks is developing sources of financing acceptable to both sellers and buyers in real estate transactions. This is true in all specialization's of real estate practice.

- **Residential Sales** – Sales of new and existing properties ordinarily depend upon the availability of satisfactory financing.

- **Income Property Sales** – Because of the importance of cash flow and leverage, income property sales are almost entirely dependent upon the arrangement of financing satisfactory to both the buyer and seller. This may involve:

  - Primary financing – First mortgage loans.

  - Secondary financing, from the seller or outside lender.

  - "Wrap–around" or all–inclusive trust deed – A method by which a seller may extend credit while selling property subject to an existing loan.

  - Installment sale – A method of income–tax reporting by which a seller spreads capital gain tax over a period of time.

  - Tax–deferred exchange – A method of exchanging a property rather than selling in order to postpone the capital gains tax.

Property Management

An understanding of financing is necessary in order to manage property in an efficient and profitable manner. This frequently involves arranging refinancing, secondary financing, or alternative financing.

Loan Brokerage

Loan brokerage requires an understanding of the real estate mortgage market. The availability and cost of money affects demand. Supply and demand are basic elements which participate in determining value. Some real estate brokers find loan brokerage a profitable specialization. Prospective borrowers who understand financing can take better advantage of the many services available from loan brokers and mortgage bankers.

Loan Types

There are two types of loans (***"government participated*"** and ***"non–government participated*)"** available, with different limitations and qualifying criteria for each. Conventional loans are loans not backed up by government. Each of these will be discussed in details further in this book.

- **Government backed–loans** – These loans are made by approved institutions and mortgage companies and *insured* by the federal government. These loans must be written to FHA specifications.

    - **HUD/FHA** – These loans are made by approved institutions and mortgage companies and *insured* by the federal government. These loans must be written to FHA specifications.

    - **DVA** – These loans are made by approved institutions and mortgage companies and *guaranteed* by the federal government. They must be written to DVA specifications.

    - **Cal–Vet** – These loans are made by the State of California, Department of Veterans Affairs. They are for California veterans only, and the borrower must meet DVA's strict requirements, at the time the loan is made and after.

    Government backed loans (FHA/DVA/Cal–Vet) will be discussed in details in Chapter 5.

- **Conventional** – Conventional loans are usually written ***conforming*** to FNMA–FHLMC (Fannie Mae–Freddie Mac) practices and limitations, thus also called ***"conforming loans"***. These loans are made by institutions and mortgage companies with the expectation of selling the loans to either FNMA or FHLMC.

  While other conventional loans made without government underwriting are termed ***"nonconforming*.*"*** They may be written without conforming to the specifications and limitations of FNMA–FHLMC. If made for amounts in excess of the "conforming" limitations, they are sometimes referred to as ***"jumbos."***

Conventional loans will be discussed in details in Chapter 6.

CHAPTER QUIZ

1. Knowledge of real estate finance is not necessary for the person who plans to specialize in:

   A. Property management
   B. Appraisal
   C. Loan brokerage
   D. None of the above

2. Government influence in real estate financing is at all levels:

   A. Becoming more involved
   B. Becoming less involved
   C. Stagnant
   D. None of the above

3. Prior to the mid–1930s, most real estate financing was:

   A. Fully amortized over the life of the loan
   B. Partly amortized with a large balloon payment
   C. A straight note payable interest–only, with the original loan payable in full at end of the note period
   D. None of the above

4. Which of the following is not a federal government agency established for real estate financing?

   A. Federal Housing Administration
   B. Federal Home Loan Bank Board
   C. Federal Bank Board Administration
   D. Federal National Mortgage Association

5. One of the most significant changes in the mortgage money market in the mid–1930s was:

A. The availability of unlimited funds for mortgage financing
B. A secondary money market for mortgage notes on a nationwide basis
C. The absolute control of mortgage financing by the federal government
D. The rise of nonstandard methods of appraisal and property valuation throughout the United States

6. The relatively sudden flow of funds out of thrift institutions into the stock market is called

A. Reverse annuity.
B. Disintermediation.
C. Re-intermediation.
D. Variable annuity.

7. As a result of the high foreclosure rates during the Great Depression, the real estate industry made long strides toward professionalization in the areas of property management and valuation. This was due to:

A. The need by lenders for expert management of properties they acquired through default
B. New government regulation of the real estate industry
C. Buyer rejection of the old methods
The introduction of the **"**Code of Ethics**"** by the NAR

8. Financing is important to the real estate industry in terms of:

A. Property management
B. Real estate brokerage
C. Land development
D. All of the above

9. As security for a loan, land is often a sound basis for collateral due to its:

A. Fixed location
B. Non susceptibility to government regulation
C. Indestructibility
D. Both A and C.

10. An advantage to obtaining a loan to buy property is to:

A. Avoid attorney fees

B. Utilize leverage
C. Avoid the loan being sold to the secondary mortgage market
D. None of the above

Answer Key: 1–D, 2–A, 3–A, 4–C, 5–C, 6–B, 7–A, 8–D, 9–D, 10–B

CHAPTER 2: THE MONEY MARKET

PREVIEW

The United States is predominantly a credit society, not a debt society. This means that we spend money now and pay for the item later, and most the time we spend on borrowed money.

In this chapter we will discuss the meaning of money, how is money/mortgage supplied, its flow and the mortgage market with emphasis on California mortgage market.

MONEY & THE MONEY SUPPLY

The quantity of money available in the United States for expenditures at any given time is called the ***"money supply"***.

Definition

According to the Board of Governors of the Federal Reserve Bank System, money is anything that serves as a generally accepted medium of exchange, a standard of value, and a means to save or store purchasing power. In the United States, paper currency (Federal Reserve notes), coin, and funds in checking and similar accounts at depository institutions are examples of money.

☞***Our monetary system is based on standards of confidence.***

☞***Our money stock can be categorized as M1, M2 or M3:***

- **M1** is the sum of currency held by the public, plus travelers checks, plus demand deposits, plus other checkable deposits (i.e., *negotiable order of withdrawal* accounts, and *automatic transfer service* accounts and credit union share drafts).

- **M2** is M1 plus savings accounts and small–denomination time deposits (less than $100,000), plus shares in money market mutual funds (other than those restricted to Institutional investors), plus overnight Eurodollars and repurchase agreements.

- **M3** is M2 plus large–denomination time deposits ($100,000 or more) at all depository institutions, large denomination term repurchase agreements, and shares in money market mutual funds restricted to Institutional investors.

MORTGAGE MONEY – SUPPLY AND DEMAND

As a commodity sought by borrowers, mortgage money is subject to the laws of supply and demand. As for any commodity, various factors affect the supply offered and the amount demanded, and thus the market price.

SUPPLY

The ultimate source of mortgage money is savings. This may be in the form of savings accounts, life insurance, corporate reserves, pension funds, etc. It is invested in mortgages either directly or indirectly.

- **Direct** – Savings are invested in mortgages directly by the saver or through a loan broker. This method accounts for a substantial portion of all mortgages and trust deeds in the United States.

- **Indirect** – Savings deposits are invested in the mortgage market through an intermediary such as a bank, savings and loan, insurance company, REIT, or other syndication. Usually the saver is not aware of the investment since the main concern is safety and interest rate.

2. THE MONEY MARKET

INFLUENCES ON SUPPLY

Money and credit flow throughout the economy of this country. Money which is not used by the people or institutions possessing it for their daily living and operating expenses is put aside for future use.

- **Competition for Supply** – Where surplus money goes greatly depends upon who is willing to pay the most for its use. Those needing the money will bid for its use. According to the law of supply and demand, it will go to the highest bidder.

- **Effect on Mortgage Funds** – How much money goes into the mortgage market depends on the interest offered for the use of the money and the total supply of money available. Traditionally, when money is **"**tight**"** the real estate market loses it to other users of money (markets) as they will bid higher interest based on use for a shorter term.

DEMAND FOR MORTGAGE MONEY

Sources of demand for loan funds include all aspects of the real estate market, such as construction, sale and purchase for personal use or for investment, and refinancing.

NEW CONSTRUCTION

Construction involves major up–front costs which are not repaid until the project is completed and sold or put into use. For this reason, construction financing is almost always necessary, whatever the structure of the project.

A contractor generally builds according to the plans of the owner. Usually, a general contractor hires and supervises all subcontractors used on a job. Common contracts that determine how a general contractor is paid, such as: installment contract, lump sum contract, cost–plus–price contract, and guaranteed price contract.

- **Owner**–**Builder Work** – An owner acts on his own behalf rather than through a general contractor and hires contractors (**"**subs**"**) to handle the work. Heavy construction jobs done by major corporations or by government agencies often use this method.

- **Speculation** – Most housing tracts and many commercial and industrial buildings are constructed at the contractor's own expense in hopes of selling at a profit after completion.

Sale Financing

The most common source of demand for mortgage money is the financing of a property to make it possible for a buyer to make a purchase. This is true for both new and resale properties.

Refinancing

This is usually the replacement of an old loan with a new loan in order to:

- Pay for rehabilitation or modernization
- Obtain more advantageous loan terms
- Consolidate two or more loans in a single mortgage or trust deed
- Raise money for other purposes.

Strength of Demand

International, national, local and Institutional factors all affect the strength of demand for mortgage money. Effective demand is demand backed by ability to pay. Two major factors affecting the strength of effective demand are:

- **Loan–to–Value Ratio** – This is usually expressed as a percentage. It is the relationship between the mortgage loan amount and the appraised value of a property. The higher the loan–to–value ratio, the smaller the down payment needed.

  ☞ ***Example***

  If a home is appraised at $100,000 and the lender will lend $50,000, then the loan–to–value ratio is: $50,000 / $100,000 = 1/2 = 50% loan–to–value ratio.

- **Loan terms** – Terms are the conditions for borrowing the money: length of loan, amount lent, monthly payments, interest rate, etc. These directly affect the cost of the loan.

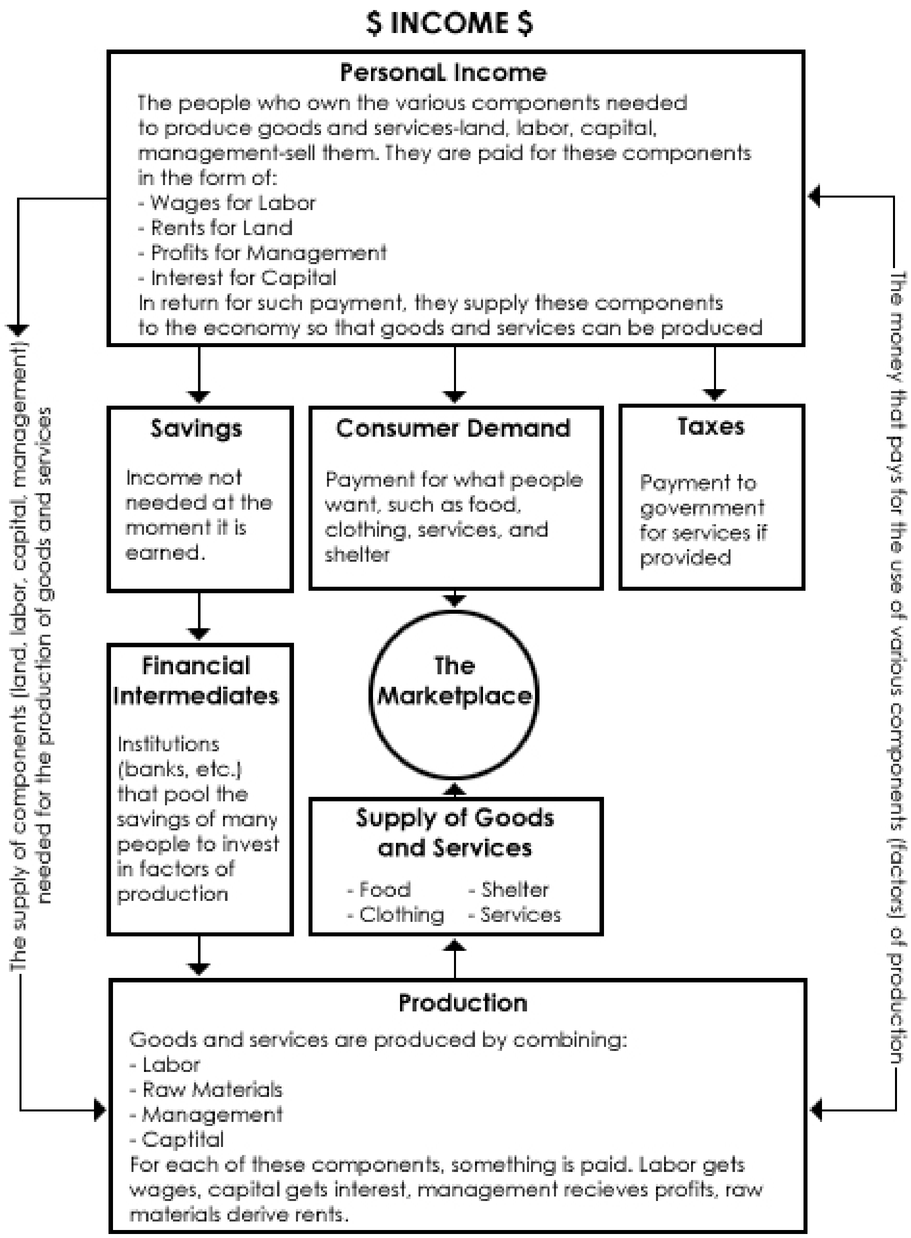
THE FLOW OF MONEY

The real estate financing occurs through a process called the *flow of the money.*

The production of goods and services requires that money be paid for the use of labor, raw materials, management, and capital as illustrated in Figure 2–1. This money is called *personal income*, and all or some of it may be taxed, spent on goods and services, or saved. That which is saved is usually deposited in financial intermediaries, which, in turn, pump funds back into production.

Figure 2–1 is a simplified model of how savings accumulate to become the reservoir for future loans. Carefully trace this circular flow until you understand that individuals "own" land, labor, capital, and management (the supply components), and businesses need these supply components to produce. Thus, businesses "buy" land, labor, and capital from individuals, thereby giving individuals income in the form of wages, rents, interest, and profits. This personal income is then taxed, spent, or saved. That which is saved becomes capital for borrowing.

Figure 2–1: The Flow of National Economy



INTERMEDIATION AND DISINTERMEDIATION

Whenever institutional lenders (to be discussed in Chapter 3), or any lenders who accumulate funds from outside sources are discussed, two important terms must be understood. One is ***intermediation***, the term used for the gathering of funds by a lender and then the lending or supplying of the funds to a borrower. Thus, the lender is serving as an ***intermediary***, or go–between, between persons with funds and the person who needs funds. As we shall see in this chapter, this process is very important to the real estate industry.

The opposite of intermediation is ***disintermediation***. This is the taking out or the withdrawal of funds from the institutional lender and the reinvesting in some other savings instrument with a higher yield. Disintermediation was a very important action that happened during the recession of 1979–1981. Depositors were withdrawing their savings from the savings associations in record amounts in order to try to keep up with inflation. The term became frequently used during the recession, and it has a great impact on the real estate market. The more disintermediation, the fewer funds there are available to lenders to make real estate loans. Now that we have some idea of what an institutional lender is, let us see how mortgage loans are distributed among the institutional lenders.

According to the circular flow of the economy, income that is not taxed away or consumed in the marketplace represents savings. Where these savings go depends largely on the kinds of returns desired by the saver. Many dollars flow into savings or commercial bank accounts, CDs, credit unions, life insurance premiums, and so on.

If people suddenly withdraw their savings and buy government notes and money market funds, the supply of mortgage money declines and the real estate market can enter into a deep slump.

REINTERMEDIATION

When the flow of savings again returns to the thrift institutions that act as intermediaries for the placement of mortgage loans, this process is referred to as reintermediation. If yields on government bonds plunge or the stock market crashes, money may reenter banks and thrift institutions in search of safety. As money returns to thrift institutions, the funds available for real estate loans increase, interest rates soften, more buyers can qualify for loans, and the housing market begins to pick up.

Thus the processes of intermediation, disintermediation, and reintermediation all have a dramatic impact on the real estate market. To understand this process fully, we must examine the role of the Federal Reserve System and the U.S. Treasury.

COST FACTORS OF MORTGAGE MONEY

Money and credit are commodities. The cost of money depends on supply and demand because it is bought, sold, and leased just as is real estate or any other commodity. The following are factors affecting cost.

INTERNATIONAL FACTORS

The world's economies are so interdependent that the mortgage money market in the U.S. cannot be considered apart from the international context.

- **Stability** – Countries of the world trade among themselves. A major crisis in any one country can affect economic conditions in other countries. This is why the United States is concerned with the economic stability of the world as a whole.
- **Balance of Payments** – Countries incur and settle debts with each other as individuals do. This financial relationship between countries is known as the **"**balance of payments.**"** When a country owes more money than it earns, it has an unfavorable balance of payments.
- **Interest Rates** – To correct an unfavorable balance of payments, a country seeks to lure money into its banks by offering higher interest rates than are offered elsewhere in hopes of attracting deposits in cash. This action, in turn, may increase interest rates on financing.

NATIONAL FACTORS

The pattern of changes reflecting the fluctuations of economic growth, employment, and prices is called the *business cycle*. Interest rates, real estate prices, and lenders' policies all vary with the ups and downs of the business cycle.

The **business cycle** is usually defined as having four phases:

- **Prosperity** – Expansion and good times.
- **Recession** – Conditions turning downward.

- **Trough or depression** – Lowest point of a contraction, after which conditions turn upward for a period of recovery.
- **Recovery** – Conditions turning upward.
- **Types and lengths of cycles** – Major business cycles can last from 6 to 13 years. Minor cycles may last 2 to 9 years. Usually real estate cycles and business cycles do not exactly coincide. Generally, the real estate market decline precedes the decline in the business activity cycle. Conversely, the tendency of the business cycle is to recover prior to the real estate cycle.

Figure 2-1: Business Cycle

CAUSES OF THE BUSINESS CYCLE

Many variables change, amplify, or subdue the movement of the business cycle. They include:

- **Internal influences** – Some influences are directly economic in nature, resulting from regulatory and market activities.

- **Government policy** – The government has extensive influence on:

- **Monetary conditions** – Interest rate and credit availability.

- **Spending** – Saving and investment vs. consumption.

- **Taxes** and government spending.

- **Market psychology** – The human element. Consumers and investors will often act according to how they feel, despite what is actually happening.

- **Prices** – When prices increase faster than income levels, inflation is amplified and consumption is reduced.

- **External influences** – Conditions which arise outside economic circles also affect the business climate, both nationally and locally.

  - **Weather** – Abnormal weather conditions, like prolonged cold spells or drought, can affect agriculture, transportation, and industrial production as well as public psychology.

  - **Catastrophe** – Earthquakes, floods, and fires present severe, unexpected strains on local resources, which may ripple throughout the economy.

  - **War** – Causes increased military spending and affects allocation of industry and manpower.

  - **Population** – Changes in the median age of the population affect consumption patterns. Migration into or out of a nation or locality is another powerful influence.

Local Factors

Every locality has its own economy, whose strength and fluctuations will differ somewhat from the national business cycle because of distinctive local conditions.

- **Employment** – Availability of jobs affects personal income, which affects the demand for housing which in turn influences the demand for mortgage money.
- **Population** – The number of people requiring housing determines the need for mortgage money.
- **Demographics** – Such variables as age composition and family structure of the local population affect the housing and mortgage markets. For example, the majority of buyers are traditionally 25–44 years of age.
- **Government** – Local government policies (taxes, zoning, services, etc.) are a major factor in determining the costs to build and own properly.
- **Climate** – Weather conditions affect costs of construction and maintenance; costs are often less in mild climates.
- **Development level** – In a fully developed community, demand for new construction is less than demand to refinance for rehabilitation. Financing for rehabilitation tends to be less expensive than for new construction.

INSTITUTIONAL FACTORS

As a rule of thumb, it takes a spread of 2% to 5% between the interest paid by lenders and the interest paid to lenders for them to break even. Individual Institutional lenders vary in where they set this ratio. Normally, the cost of borrowing mortgage money fluctuates depending upon the following considerations affecting lenders:

- **Deposit Cost** – The cost of obtaining money from depositors, in order to have money to offer borrowers.
  - How much interest must savers be paid in order to attract their money into lending institutions?
  - What is the cost of advertising and promotion in order to attract savers?
- **Sales Cost** – The cost of marketing loans to borrowers.
  - What are the costs involved in attracting loans?

- How much must be spent to get good loan applications coming steadily in to the lender?

- **Administration** – How much does it cost to operate the institution, taking into account rent, utilities, salaries, overhead, etc.?

- **Reserves** – What legal reserves must be set aside?

- **Profit** – How much profit can reasonably be expected?

EFFECTS OF THE BUSINESS CYCLE

The ups and downs of the business cycle affect the housing and mortgage markets especially through fluctuations in employment and inflation.

- **Employment** – During an upswing (recovery and prosperity), demand increases production, thereby increasing employment. During a downswing (recession and depression), employers decrease production due to lack of demand and employment decreases. Lower employment means less effective demand for all commodities, including mortgage money.

- **Inflation** – Inflation directly affects prices and the value of money, and has pervasive effects on public psychology as well as on spending patterns.

    - During an upswing, as the repressed demand is released, employers increase production to meet this demand, and employment is increased. In the interim of production's lag time, demand exceeds supply and prices increase, resulting in inflation.

    - During a downswing, when prices rise to a point where demand is no longer effective, supply will exceed demand and result in lower prices (deflation), and decrease in employment (some unemployment is considered necessary to curb inflation).

- **Stagflation** – A period of rapid inflation during a recessionary economy. It first appeared in the U.S. in the 1970s. Consumption remains strong because of the fear of further price increases, while production falls behind because of the fear of recession, overstocking, and high operating costs.

Fiscal Policy

The U.S. Congress influences the direction of the economy through the effect of government spending and taxation. The executive branch is also a major influence through budgets submitted to the Congress. The nation's fiscal agent is the U.S. Treasury Department.

- **Government spending** – During a recession, the government tends to increase spending to encourage consumption.
- **Taxation** – During recessions, tax cuts increase the available money supply and encourage spending.
- **No simple solutions** – During a period of stagflation, as the economy is pulled in opposite directions, the task of regulating government spending and taxation becomes exceedingly difficult.

Characteristics of Real Estate

- **Local** – Each parcel of real estate is unique. In this sense, then, so is each real estate loan, as most lenders lend in their own local geographic areas, and each risk must be individually evaluated.
- **Complex** – Each parcel of real estate, especially an improved parcel, is composed of many legal rights and interests. Any mortgage secured by this real estate becomes involved in these complexities.
- **Durable** – Real estate is virtually indestructible, and can be financed over a long period of time. The decision to purchase real property is generally not only a long–term commitment for the buyer, but is also a long–term commitment for the lender.
- **Expensive** – Real estate, particularly improved real estate, is expensive because of its unique, durable, and complex nature and, therefore, requires a relatively large amount of mortgage money to purchase.

THE CALIFORNIA MORTGAGE MARKET

There are several characteristics of real estate which set it apart from other investments, and are reflected in the mortgage market. These characteristics are all subject to local and regional variation, and California manifests them in unique ways.

WARMER, MILDER CLIMATE

- **High demand** – California has a large population with a fast growth rate and high demand. California is the most populous state, continues to attract new residents, and has a high birth rate. State officials expect California's population to rise from approximately 33 million in the year 2002 to 60 million by 2040!

WIDE DIVERSIFICATION OF INDUSTRY AND AGRICULTURE

- **Diversity** – California's economy is one of the most diversified worldwide and is growing with a mix of ethnic and social diversity that is creating new opportunities for housing and financing.

- **Financial institutions** – California contains the largest number of banks and thrift institutions. Obviously, thrift institutions want to be where the greatest demand for real estate loans can be found. Californians have a greater choice of lenders than do residents of other states.

- **Loan correspondents** – California has attracted many experienced and diversified mortgage loan correspondents who represent out–of–state life insurance companies and other Institutional and non–Institutional lenders. This brings additional mortgage money to California.

WIDE USE OF TITLE INSURANCE AND ESCROWS, LESS COMMON IN OTHER STATES

- **Title companies** – Title insurance originated in California and it continues to increase in volume. Escrow companies, too, are peculiar to this state, though the use of both title and escrow firms is spreading to other states. This easy, low–cost closing process attracts lenders and borrowers.

USE OF TRUST DEEDS INSTEAD OF MORTGAGES TO SECURE REAL ESTATE LOANS

- **Loan document** – In California the **deed of trust** is used almost exclusively, rather than the mortgage instrument, as the legal basis for securing real estate loans. This gives greater protection to lenders, because it allows a quick foreclosure process.

- **Active secondary market** – This is where existing real estate loans are sold to in–state and out–of–state purchasers. These secondary market sales bring fresh capital to the California real estate market.

MONEY IN THE ECONOMY

The following excerpts are from the booklet **"Money in the Economy"**, published by the Research and Public Information, Department of the Federal Reserve, Bank of San Francisco. It spells out in more detail the monetary principles summarized in this and the preceding chapter.

Most of us take it for granted that money and credit conditions have important effects on our personal financial affairs and on the nation's economic performance. Yet many people are unsure how monetary policy affects our nation's economy and even less certain how it is carried out. This booklet has been prepared to throw light on these subjects

We begin by explaining what economists mean when they talk about "money", and how banks and other depository institutions can "create" money. We then explain how monetary policy is made in the United States and describe the policy instruments the Federal Reserve System has at its disposal to control the size of the money supply–the total amount of money circulating in the national economy. This leads us to a discussion of how Federal Reserve actions in making the money supply grow faster or slower affect important economic magnitudes like interest rates, unemployment, and inflation. Finally, we describe the operating procedure used by the Federal Reserve to carry out monetary policy.

THE PROCESS OF MONEY CREATION

DEFINING MONEY

Money is customarily defined by what it does. Since money's traditional and most important role is as a medium of exchange, that is, as a means of making payments, it is usually defined to include all of the things that people generally accept in payment. In the U.S., roughly nine–tenths of all payments are made by check and check–like instruments, with currency transactions making up the balance. Hence the measure of the nation's money supply which most economists prefer is the total of the public's holdings of currency and of deposits on which checks can be written.

☞ ***This measure of the money supply is referred to by the Federal Reserve as M1.***

Until recently, commercial banks were unique in being able to offer deposits on which checks could be written. As late as 1980, these traditional checking accounts, called demand deposits, accounted for more than 90% of all checkable deposits. Since the late 1970's, however, regulatory and Institutional changes have both expanded the range of checkable deposits that banks can offer and made it possible for thrift institutions–savings and loan associations, mutual savings banks and credit unions–also to issue some types of checkable deposits.

Thus, the deposit component of M1 now includes not only demand deposits issued by banks, but also ATS (Automatic Transfer to Savings), NOW (Negotiable Orders of Withdrawal) and Super–NOW accounts offered by banks and thrifts, and share draft accounts issued by credit unions. These new types of checkable deposits pay interest, while demand deposits do not. By the end of 1983, demand deposits' share of total checkable deposits had fallen to 65 percent.

The M1 measure of money often is referred to as the **"**Transactions definition**"** of money because it confines money to those things that can be used directly to make payments: checkable deposits and currency. The Federal Reserve also computes and publishes two broader measures of money–M2 and M3. These other measures recognize that there are a number of different types of deposits and other financial assets that can readily be converted into a spendable form even though they cannot themselves be used to make payments.

Passbook savings and time accounts at banks and thrifts are a familiar example of this type of asset. Accounts at money market mutual funds are another example. These highly liquid assets are added to those comprising M1 to make M2 and M3. These broader measures of money are used to gauge the amount of readily spendable funds at the public's disposal.

CREATING MONEY

Depository institutions–banks and thrifts operate under a fractional–reserve system: each institution is required by Federal law to hold reserves equal to a certain fraction of specified types of deposits. These required reserves can be held either as vault cash (currency on hand) or as deposits at a Federal Reserve Bank.

Reserve requirements have not always been uniform across institutions. Prior to passage of the Depository Institutions Deregulation and Monetary Control Act in 1980, only banks that belonged to the Federal Reserve System, called member banks, were subject to reserve requirements set by the System. Non–member banks, which accounted for approximately 30% of total demand deposits, were subject to the reserve requirement set by the states in which they were located. These state–mandated reserve requirements were on average lower than the Fed's requirements. More importantly, in many states, banks could include as reserves such assets as government securities over which the Federal Reserve had no control. Finally, thrift institutions were not subject to reserve requirements at all.

Because the Fed paid no interest on reserves, these differences gave rise to a highly inequitable situation in which the costs of reserve requirements were significantly higher for member banks than for nonmembers and thrift institutions. The result was a progressive deterioration in the Federal Reserve's control over the money supply as more and more banks rejected System membership. The Congress dealt with this problem in the Monetary Control Act of 1980. When the provisions of this Act are fully phased in, the checkable deposits of all depository institutions will be subject to uniform reserve requirements set by the Federal Reserve. As a result, the System's control of the money supply will be significantly enhanced and inequities reduced.

The system of fractional reserve banking (in what follows we shall often refer to all depository institutions as banks) means that total deposits issued by banks are a multiple of the amount of reserves they have on hand or on deposit with Federal Reserve Banks. For example, if the average required reserve ratio were 12% (the rate that ultimately will be effective on most transactions accounts under the 1980 Monetary Control Act), banks would be able to issue $8.33 of deposits for every dollar of reserves they have. When the amount of reserves in the banking system changes, a chain reaction is set off that eventually causes the total amount of deposits issued to change by the same multiple as the change in reserves. In our hypothetical example, a receipt of $1 of additional reserves by the banking system would ultimately cause deposits to rise by $8.33. Conversely, a $1 reduction in reserves would cause deposits to shrink by $8.33. The Federal Reserve is able to control the total money supply because, although an individual bank can increase or decrease its reserves (for example, by buying them from or selling them to other banks), the total amount of reserves available to the banking system as a whole is determined by the Federal Reserve.

The multiple expansion or contraction of bank deposits in response to a change in the quantity of reserves occurs because banks and other depository institutions have the power to create new deposits and either lend them out to customers or use them to purchase investments such as government securities. If a bank decides that it is profitable to lend to a car dealer, for example, it credits the dealer's checking account at the bank with the amount of the loan. Conversely, when the dealer repays the loan out of his checking account, the bank simply reduces the deposit correspondingly. Deposits, in other words, can be created and destroyed with the stroke of a pen, or perhaps more accurately in today's environment, by the stroke of a computer key.

However, there is a limit on this power to create deposits: depository institutions must have reserves prescribed by the law to back any new deposits they create. In other words, a bank has the opportunity to create new deposits – to make new loans and investments only when it receives new reserves to back the new deposits. For example, suppose a bank receives an additional $1,000 in new reserves (through open market operations by the Fed, described below, which are the most important source of new reserves to banks) and the required reserve ratio is 10 percent, that is, banks must have reserves equal to 10% of their deposits. If our hypothetical bank were the only bank in the system, it would calculate that the additional $1,000 in reserves would allow it to create new deposits of $10,000 to fund new loans and investments ($1,000 of additional reserves = .10 x $10,000 of new deposits).

MULTIPLE BANK SYSTEM

In reality, the bank will be much more conservative in extending loans because it is not operating alone. There are approximately 35,000 depository institutions operating in the U.S. A bank recognizes that a large part of any new deposits it creates will be spent and re–deposited in other banks. As a result, the bank will have to transfer reserves to those other banks. To protect itself from losing too many of its reserves, a bank originating loans will limit the new deposits it creates.

A bank is therefore likely to make a loan for no more than the full amount of its excess reserves –reserves in excess of what it is required to hold. In our hypothetical example, the bank initially has excess reserves of $1,000. Suppose it makes a loan to a car dealer of $1,000 to buy automotive parts. The bank opens a new account for the dealer and credits it with $1,000 of new deposits. The dealer will write a check on his new account to pay the parts supplier, who in turn will deposit the check in his account at another bank. The second bank will credit the supplier's account with the amount of the check and return the check to the first bank for settlement. The first bank will settle this check by transferring $1,000 of reserves to the second one and thus will no longer have any excess reserves. Thus, its ability to create new deposits is over.

At this point, however, the second bank has $1,000 of additional deposits and an equal amount of new reserves. This second bank, which must hold required reserves of .10 x $1,000 = $100 against the increase in its deposits, has gained excess reserves of $900. It, therefore, will try to make a new loan for $900 and fund this loan by creating new deposits of $900. The new money created up to this stage is $1,000 + $900 or $1900. The new borrower will draw on his new deposit to make purchases and the check will end up in other banks; the $900 in excess reserves will be transferred to those other banks and they in turn will make new loans or investments by creating additional new deposits.

At each stage of the process, excess reserves available to be "lent out" are smaller than at the last stage by 10 percent, meaning that the amount of new loans and deposits created at each stage gets progressively smaller. Eventually, there will be no excess reserves left because the accumulated value of all new deposits created will require reserves backing equal to the amount of new reserves that started the whole process. In our example, excess reserves are used up when total new deposits created reach $10,000. This is how the banking system creates a multiple of new deposits when it receives new reserves. Conversely, when the banking system loses reserves, it goes through a series of reductions in loans and investments, destroying deposits in the process until they are brought back into line with the amount of reserves available to back them.

Tools of Monetary Policy

The Federal Reserve can change the amount of deposits banks issue (and hence the size of the money supply) by altering the amount of reserves available that economists call the supply of reserves. The principal tool the Fed uses to add reserves to, or drain them from, the banking system is open market operations. These consist of buying or selling government securities in the open market. The Fed also can affect the supply of reserves indirectly by changing the discount rate, the rate it charges depository institutions when they borrow from Federal Reserve Banks. Finally, the Federal Reserve can change bank's need, or demand, for reserves by changing reserve requirements – the fraction of deposits that must be matched by reserves – within limits set by laws. The ways in which these tools of monetary policy affect the supply of money are discussed in detail below.

Components of the Money Supply

In judging the adequacy of the money supply, the Federal Reserve is concerned with its overall size, not with its components – currency and deposits. It attempts to accommodate any changes in the public's preference for using currency rather than checking accounts to make payments. If the public wants to hold more currency and fewer deposits, for example, the Federal Reserve will simultaneously provide more currency to banks for their customers and drain enough reserves from the banking system to ensure that deposits tall by the increase in currency outstanding. In this way, it keeps the total amount of money–currency plus deposits – unchanged.

OPEN MARKET OPERATIONS

Open market operations affect non–borrowed reserves–those not provided by the Fed through loans to depository institutions. Non–borrowed reserves typically account for about 98% of total reserves. Since open market operations are the major source of changes in non–borrowed reserves, they comprise the Fed's principal instrument for controlling total reserves.

Open market operations for the Federal Reserves System are carried out by the Trading Desk of the Federal Reserve Bank of New York. An example of such operations is when the Trading Desk makes an open market purchase of a government security from a government securities dealer (which is a specialized financial firm engaged in the buying and selling of government securities). The New York Federal Reserve Bank pays for these securities with a check drawn on itself. When the securities dealer deposits this check in its account at a commercial bank, the bank will send the check for collection to the Federal Reserve Bank which honors it by simply crediting the bank's deposit account with itself. The commercial bank gains additional reserves because its deposits at the Federal Reverse Bank count as reserves. An open market purchase, therefore, creates an equal dollar volume of reserves. Conversely, an open market sale reduces reserves by the amount of the sale.

BORROWINGS AND THE DISCOUNT RATE

Banks and other depository institutions also can borrow on a temporary basis from Reserve Banks within guidelines set by the System. Such borrowing through the ***"discount window"***, as it is commonly called, normally supplies only about 2% of total reserves. However, it provides an important **"**safety valve**"** for individual institutions that find themselves temporarily short of reserves because of unexpected large withdrawals and the like. Guidelines set by Reserve Banks for borrowing through the discount window are intended to prevent depository institutions from borrowing for extended periods of time except under special circumstances. Even so, changes in borrowed reserve associated with the spread between market rates of interest and the discount rate often can lead to a significant change in total reserves for periods as long as 2 to 3 months.

Higher or lower discount window borrowing adds to or subtracts from the total supply of reserves and thereby affects the amount of deposits banks and other depository institutions can support with a given provision of nonborrowed reserves. At times, fluctuations in borrowed reserves may pose a potential problem for monetary control by causing total reserves and hence the money supply to diverge from the Federal Reserve's goals. To offset such changes in borrowing, the Federal Reserve may adjust the discount rate: raising the rate when borrowing is too high and lowering it when borrowing is too low. Alternatively, to a degree, the Federal Reserve could offset the effects of variations in borrowed reserves by altering the supply of non–borrowed reserves.

In addition to adjusting the discount rate for changes in market rates, the Federal Reserve sometimes uses discount rate changes for their "announcement" effects, that is, as a way of signaling or announcing to markets a significant change in monetary policy. A higher discount rate can be used to indicate a more restrictive policy, while a lower rate may signal a more expansionary policy. For example, in the dollar–rescue operation of November 1978 and in the anti–inflation measures of October 1979, both of which required a more restrictive monetary policy, the Federal Reserve signaled its intentions by raising the discount rate by then–unprecedented increases of 1 percentage point.

Changes in Reserve Requirements

In principle, the Federal Reserve has a third monetary policy tool at its disposal: it has the power to change, within statutory limits, the reserve–requirement ratio. This ratio specifies the amount of reserves that depository institutions must have for each dollar of deposits. Changes in the ratio alter the dollar amount of reserves that depository institutions must hold against their deposits; in other words, they affect their demand for reserves.

Changes in the demand for reserves can have the same effects as reducing the supply of reserves. A reduction in reserve requirements, for example, would mean that institutions would find that their existing reserves holdings are in excess of what they are required to hold under new, lower requirements.

Reducing reserve requirement therefore is equivalent to increasing the supply of reserves: it starts the process of multiple expansion of loans and deposits described earlier, and the process continues until the excess reserves have disappeared. By the same token, an increase in reserve requirements is equivalent to a reduction in reserve supply, causing a multiple contraction in deposits outstanding.

In current practice, changes in reserve requirements are seldom used to control money. They are considered too "blunt" an instrument in the sense that relatively small changes in requirements can produce large increases or decreases in money. Moreover, changes in reserve requirements can affect the profitability of depository institutions since they change the ratio of non–earning assets (reserves) to deposits in these institutions.

MONETARY POLICY

The United States is unique in having a central bank that is federal rather than unitary in structure. Established in 1913, the Federal Reserve System consists of the Board of Governors in Washington, D.C., and twelve regional Federal Reserve Banks which are the operating arms of the System. The Federal Reserve Bank of San Francisco represents the Twelfth District. Although primary responsibility for monetary policy rests with the Board, the Reserve Banks also have a role to play. The Board of Governors consists of seven officials who are appointed to fourteen–year terms by the President of the United States and confirmed by the Senate. The Chairman of the Board is appointed by the President and serves for tour years, but may be reappointed. The System meets its operating expenses primarily from the interest earnings from its portfolio of securities and thus is not subject to the Congressional appropriations process. The founders of the System believed it was necessary to separate the people who frame the government's spending decisions and the people who control the supply of money, and devised the Institutional structure with this view in mind.

Although the Federal Reserve is ultimately responsible to Congress, it is an independent agency within the federal government. The Chairman and other Governors report regularly to the Congress and meet also with senior administration officials in order to coordinate monetary policy with the government's overall economic program. Each Reserve Bank is headed by a President who is appointed by the Bank's Board of Directors, subject to final approval by the Board of Governors in Washington. The Directors are chosen to provide a representative cross section of interests in their communities. Their varied backgrounds and wide experience provide the System with a "grass–roots" informational network that helps to ensure that policy reflects the views and interests of the various parts of the nation.

Decisions regarding open market operations are made by the twelve–member Federal Open Market Committee, or FOMC. The decisions of this Committee are transmitted to the Trading Desk of the Federal Reserve Bank of New York which conducts the actual buying and selling of securities in order to influence bank reserves and thus the monetary aggregates.

With regard to discount policy, the Board of Directors of the Reserve Banks make recommendations as to changes in the discount rate. However, final approval rests with the Board of Governors. Additionally, the Board of Governors has sole authority with regard to reserve requirements.

OBJECTIVES OF MONETARY POLICY

The objectives of U.S. monetary policy are high employment, stable prices (no inflation), and steady growth in the nation's productive capacity, and a stable foreign exchange value for the dollar. These ultimate goals, as they are often described, are not directly under the control of the Federal Reserve. Monetary policy can only pursue what is called an intermediate target strategy. This strategy consists of targeting some economic variable that is subject to the Federal Reserve's control, that is related to the ultimate goals in ways that are understood and reasonably predictable, and that is effective in helping the economy reach those ultimate goals.

Since the middle 1970s, the Federal Reserve has pursued an intermediate target strategy based on the monetary aggregates. Over this period M1 and M2 have been the Federal Reserve's principal targets. The System first determines growth targets for these monetary aggregates that are thought to be consistent with its objectives for unemployment, inflation, economic growth, and a stable foreign exchange value for the U.S. dollar. It then uses the monetary policy instruments at its disposal to achieve the targeted growth in money, expecting that such growth will advance the economy toward the ultimate goals.

THE TRANSMISSION MECHANISM

Targeting the monetary aggregates makes sense only if the Federal Reserve can predict what effect these aggregates will have on the economy. The policy–maker needs to know, in other words, the links between money and the objectives of monetary policy. The chain of reactions in the economy that transmits changes in money growth to the levels of unemployment and inflations referred to by economists as the transmission mechanism. We will now broadly outline the mechanism and review this historical evidence on the connection between money growth and the U.S. economy.

Consider the results of an open–market purchase of securities. Such a purchase expands total bank reserves, leading to a multiple expansion of loans and investments. The addition to bank credit increases the supply of loanable funds in the economy, thereby putting downward pressure on interest rates in the short run. Since the credit market is highly competitive, all interest rates, not only the rates on securities banks buy or the rates they charge on their loans are reduced.

Lower interest rates and a greater availability of credit tend to stimulate spending on durable goods of all kinds – on new factories and houses, on business equipment and inventories, and on customer durables such as automobiles. As the rates investors can earn on financial instruments fall, yields on common stocks become more attractive, causing investors to bid their prices up. Households with stocks in their portfolios find that the value of their holdings has gone up, and this increase in their wealth prompts them to increase consumption expenditures.

Higher expenditures raise output and employment which, in turn, stimulate business capital–goods spending even further by making greater demands on existing plant capacity. They also boost consumption further because of the income gains that result from the higher level of employment activity.

Lags in Monetary Policy

The effects of a monetary expansion on aggregate spending, output and employment usually begin to show up six to nine months later, that is, with a lag of two to three calendar quarters. Specifically, changes in the growth rate of real M1 (M1 adjusted for price–level changes) tend to be followed about two quarters later by similar changes in the growth rate of real, or inflation–adjusted, gross national product (the nation's total production of goods and services). Changes in the growth of money tend to be followed about six months later by significant changes in the same direction in the growth of the nation's output of goods and services.

Historically, monetary expansion also has affected prices, although with a much longer time lag – perhaps two years or more. Thus, the good news of excessive monetary expansion usually comes first and the bad news later. Output and employment rise initially, and prices follow some time later. The explanation for this sequence is that output and employment eventually grow beyond the point where labor supply and demand are balanced. After that point, firms bid up wages in excess of labor productivity, leading to increases in unit costs and prices. Rising prices then squeeze the economy's financial liquidity as they reduce the purchasing power of the nation's money stock. Interest rates begin to rise and dampen spending. Output and employment consequently tend to move back to the levels that existed before the monetary expansion began. By the time the price effects of an excessive monetary expansion are felt in their entirety, the stimulus to output and employment may have largely evaporated.

The task of fighting inflation is complicated by the different lags in the impacts of monetary policy on output. To avoid spurring inflation, policymakers must guard against staying with expansionary policies too long, although this may be difficult to do since the favorable effect on output and employment are the first to surface while the unfavorable effects on prices are long delayed. Conversely, policymakers sometimes must move to rein in inflationary excesses even though temporarily higher unemployment may precede evidence of forthcoming lower inflation.

Many economists advocate what they call a gradualist policy of fighting inflation in which money growth is systematically slowed in small steps so that the adverse side effects on unemployment and output are minimized. This strategy of gradual deceleration in monetary expansion was embodied in the Federal Reserve's program beginning in 1979 of lowering its targets for effective growth in the monetary aggregates each year.

Long–Term Policy

An anti–inflation strategy ultimately must bring monetary expansion down to a rate consistent with stable prices.

This does not mean zero growth in money because even with stable prices some growth is needed from year to year to provide for the transactions needs of a growing economy. However, this growth in money probably would not have to be as large as the long-term growth rate of the economy. At least since the end of World War II, the U.S. economy has been economizing on the amount of money it needs to carry out a given volume of transactions.

Money and Interest Rates

Monetary growth has important consequences for interest rates. These consequences are very different in the long run from what they are in the short run. Monetary expansion at first reduces interest rates by expanding the supply of funds available for borrowing. But since monetary expansion very quickly leads to an expansion in economic activity, business and households will increase their borrowing demands and this will tend to reverse the initial fall in interest rates. Moreover, if high money growth persists, it will result ultimately in higher inflation. If this occurs, lenders will demand a higher **“**inflation premium**”** in interest rates to protect the inflation–adjusted, or real, yields on their investments. Consequently, interest rates will tend to end up higher than their starting level– just the opposite of the short–run effect.

The misperception that easy money can permanently lower interest rates is based solely on the initial effect–an increase in the supply of loanable funds; it ignores subsequent upward pressures on interest rates caused by increased economic activity and the higher inflation that occur later.

Both changes in inflation premiums and the state of the business cycle are important determinants of short–term interest rates. Compared to their levels in earlier periods, interest rates have been high and variable since the 1970's, largely owing to historically high and variable inflation rates. Also, the state of the business cycle has influenced the timing of interest–rate movements. For example, in 1974, the interest rates started to decline before the inflation rate declined because the business–cycle recession reduced the demand for loanable funds.

STRATEGIES AND OPERATING PROCEDURES

INDICATORS OF MONETARY POLICY

Setting targets for money growth to achieve monetary policy's ultimate goals is a recent innovation in the Federal Reserve's procedures. Money–growth targets were not adopted until the early 1970's. Prior to that, the Federal Reserve (like most central banks) judged the thrust of monetary policy whether it was easy or tightly looking at interest rates. Lowering interest rates were taken as indications that monetary policy was being expansionary, while higher interest rates were judged to be a sign that monetary policy was tight. The Fed's monetary policy instruments open market operations and the discount rate–were used to adjust interest levels that were believed to be consistent with the ultimate objectives for inflation and unemployment. Thus, when the economy appeared to be overheating and to be raising the threat of inflation, open market operations were used to drain reserves and to contract deposits and bank loans so that interest rates would rise. The rise in interest rates was expected to dampen spending and to help cool off the economy. Conversely, when the economy showed signs of slipping into recession, monetary policy aimed at lowering interest rates to encourage spending and to forestall the downturn.

A MISLEADING INDICATOR

Toward the end of the 1960s, the Fed came to realize that interest rates often could be misleading indicators. Rising interest rates, for example, could be symptoms of strong credit demands fueled by a robust economy, or of rising inflation premiums as inflation began to heat up. In such cases, interpreting rising rates as signs of a restrictive monetary policy would be incorrect because they, in fact, would be signs that policy was inflationary. Similarly, falling interest rates could be symptoms of a weakening economy, not an expansionary monetary policy.

MONETARY TARGETING

Because interest rates can give misleading signals, the Federal Reserve began in the early 1970's to target monetary growth and to place less emphasis on interest rates as indicators of monetary policy. The System was concerned that if monetary policy relied predominantly on a simple interpretation of interest rate behavior, it could mistakenly aim in the wrong direction. That is, it could stay expansionary too long after an economic recovery began to turn into an inflation or remain too restrictive when the economy was in a downturn. The Federal Reserve wanted to avoid policies that might turn out to be pro–cyclical, reinforcing rather than moderating business cycle fluctuations.

Funds Rate Operating Procedure

This did not mean that interest rates totally disappeared from the picture. The Federal Reserve continued to focus on interest rates, but as an instrument for controlling money growth rather than as an indicator of policy. Specifically it used interest rates to influence the public's demand for cash balances (see **“**The Demand For Money**”**, following) and in that way affect the quantity of money out–standing.

Higher market rates of interest make it more expensive for households and businesses to keep their funds in low– or non–yielding forms such as checkable deposits or currency. Households and businesses therefore attempt to reduce the average amount of money they keep on hand when interest rates are high. Conversely, they are willing to hold larger cash balances when interest rates are low.

The open market interest rate over which the Federal Reserve has the most direct influence is the federal funds rate. This is the rate which banks pay when they borrow reserves from one another. The Federal Reserve can influence this rate via open market operations which alter the amount of non–borrowed reserves available. Sustained changes in the federal funds rate generally lead to corresponding movements in other short–term interest rates, which in turn affect the public's willingness to hold money.

In short, the Federal Reserve could dampen money growth by exerting upward pressure on interest rates through open market sales to drain reserves; the higher interest rates would reduce the public's demand for money and cause monetary growth to slow. Similarly, downward pressure on interest rates can be expected ultimately to produce faster money growth.

Shift to a Reserves Operating Procedure

While an improvement over the use of interest rates as indicators of monetary policy, the funds rate operating procedure, as it was called, was also flawed. With hindsight, it became evident that the funds rate sometimes was slow to adjust to changing economic conditions. This meant money growth tended to speed up when the economy picked up, and to fail off when the economy weakened, that is, monetary growth continued to show a pro–cyclical bias, as before.

To solve this problem, the Federal Reserve adopted a new operating procedure on October 6, 1979 through which it sought to achieve its targets for money by placing less emphasis on interest rates and focusing more on the volume of reserves available to depository institutions. The new procedure, in other words, placed more emphasis on controlling monetary growth by operating on the primary determinant of the supply of money: namely, the volume of reserves that banks and thrifts have at their disposal. Before then the operating procedure for controlling money had worked principally through the demand for money.

(Before the fall of 1982, the Fed had placed equal weight on the performance of the M1 and M2 measures of money relative to their targets. Beginning in October 1982, however, the FOMC placed less weight on the behavior of M1 because of concern that Institutional distortions and an unusual change in velocity in 1982 had reduced its usefulness as an indicator and target of monetary policy. With M1 given less emphasis, the Committee decided to place substantial weight on the broader aggregates, M2 and M3, in the belief that their performance relative to economic activity would be more predictable.)

An operating procedure focusing on reserves is subject to some uncertainties of its own. These stem in part from variability in the average relationship between reserves outstanding and the amount of checkable deposits that will be created. This relationship is called the reserve multiplier, and depends on reserve requirements, among other things. In the simple example of money creation in Section I, the multiplier was just the inverse of the required reserve ratio. In reality, things are a little more complicated. Because some liabilities of banks and thrifts other than checkable deposits also have reserve requirements, the amount of reserve available to support checkable deposits rises or falls depending on the outstanding amounts of those other reservable liabilities. A decrease in these other reservable liabilities would increase the amount of reserves that can support checkable deposits; an increase would have the opposite effect. Consequently, checkable deposits–and hence the money supply can rise or fall even though total reserves outstanding are unchanged because the multiplier has changed.

A similar problem occurs when reserves are transferred among institutions with different reserve requirements because the size of an institution's reserve requirement determines the number of dollars that it can create per dollar of reserves. A shift of reserves from an institution with high reserve requirements to another with lower requirements, for example, increases the banking system's capacity to produce deposits even though total reserves are unchanged.

In practice, the Trading Desk is generally able to deal with these problems by varying the total stock of reserves to offset changes in the multiplier.

Moreover, both problems will be much less pronounced when the provisions of the 1980 Monetary Control Act are fully phased in. Then, there will be only one class of reservable liability other than checkable deposits, and the reserve requirements on checkable deposits will be the same for all except the very smallest institutions.

The other source of uncertainty in the reserves operating procedure concerns the amount of reserves that depository institutions borrow from the Federal Reserve. As mentioned in Section II the spread between market rates of interest and the discount rate can alter the amount of discount window borrowing, with larger borrowings being associated with higher spreads. Unexpected changes in market rates of interest can alter this spread and cause borrowing to rise or fall unexpectedly, with the result that total reserves, and hence the supply of money, can change.

THE DEMAND FOR MONEY

The text describes the first link in the transmission mechanism from the perspective of the credit market, that is, in terms of an increase in bank loans and investments that causes interest rates to fall–at least initially. There is, however, an alternative way to tell this story, which is to look at what happens to the supply of money–the total amount of cash balances held by the public. The increase in bank loans and investments is funded, among other ways, by banks creating new deposits, that is, by an increase in the supply of money circulating in the economy. Thus the fall in interest rates as banks expand loans and investments is associated with an increase in the supply of money to the economy. By the same token, a smaller stock of money is associated with higher interest rates.

This behavior is consistent with what economists know about the way the public manages its cash holdings. Currency and checkable deposits either do not pay interest at all, or pay rates that for the most part are below market yields. keeping part of one's funds tied up in money therefore is expensive because it means foregoing a market yield on those funds. For that reason, businesses and households try to get by with lower cash balances when market rates of interest are high, and they are willing to keep larger amounts of money on hand when interest rates are low.

Economists call the amount of cash balances businesses and households want to hold the economy's demand for money. As we have just noted, this demand for money has been observed to be negatively related to market interest rates. That is, the higher are market rates, the lower is the amount of cash balances the public wants to hold, or, as economists would say, the lower is the quantity of money demanded by the public. By the same token, low interest rates mean a higher demand to hold money.

This negative relationship between money demand and interest rates means that an increase in the amount of money circulating in the economy–in the supply of money in other words–should lower interest rates, because if it did not, the public would find itself holding money in excess of what it wants to hold or "demand." The process by which rates are lowered has already been described: the new money is lent out by banks, adding to credit availability in the economy and causing interest rates to fall. Conversely, a lower supply of money means tighter credit and higher interest rates.

If this money demand relationship is consistent over time (economists would say, if it is a "stable" relationship) monetary policy can be formed in terms of money supply targets. If the Fed wants to be more restrictive, for example, it can set lower targets for the monetary aggregates because it can expect interest rates to rise and total spending in the economy to be dampened when these targets are hit. Conversely, it could expect higher targets for money to have an expansionary impact on the economy.

Events in recent years have raised the question of whether the economy's demand for money can in fact be known with any degree of precision. In the mid–1970s, for example, historically high interest rates combined with new and cheaper computer technology prodded banks and their customers into adopting new techniques for managing cash balances. Those "financial innovations," as they came to be called, allowed the public, especially businesses, to make everyday transactions with significantly lower holdings than before. With the benefit of hindsight, it is now possible to calculate fairly accurately the decline in the economy's demand for money during that episode. However, it was not nearly as obvious at the time. For that matter, when the episode began it was not certain that any adjustment to financial innovations was taking place; nor was it clear later on when the transition period would end. Because of these uncertainties, it was difficult for the Fed to calculate the target for money growth that would take account of both its goals for the economy and the changing cash needs of the public.

Roughly coinciding with the rapid changes in cash management practices was a proliferation of new types of liquid financial instruments and deposits, such as money market mutual funds, NOW (Negotiable Order of Withdrawal) and Super–NOW accounts, and money market deposits accounts. These developments raised two major concerns: first, that the existing definitions of money were outmoded and therefore no longer useful as guides to making policy; second, that these new types of deposits would alter the public's demand for money because their features differed from those of existing forms of money. For example, new types of checkable deposits, such as NOW accounts, paid interest while traditional checking accounts did not. NOW accounts provide households with a more attractive way of holding their money and, therefore, could be expected to raise their demand for money.

The Federal Reserve responded to the first concern by implementing a major redefinition of the monetary aggregates in February 1980. To address the second concern, the System attempted to assess the impact of the new accounts on money demand, and to "adjust" the figures for money to take into account the change in the public's preferences for cash balances. Thus, in 1981, the Federal Reserve estimated that the nationwide introduction of NOW accounts raised the public's demand for money because now they could hold the funds in interest–bearing accounts. The actual growth in money of 5.1% for 1981 was accordingly adjusted downwards to 2.2% in recognition that part of the growth in money during the year was simply to accommodate the public's increased preferences for money. In other words, the adjusted figure was a more accurate gauge of the impact of monetary policy on the economy.

CHAPTER QUIZ

1. Money is:

   A. Anything that serves as a generally accepted medium of exchange
   B. Cash only
   C. Coins only
   D. Only the things backed by gold reserves

2. Components of the money supply include:

   A. Commercial bank demand deposits
   B. Currency in circulation
   C. Coins
   D. All of the above

3. A primary source of funds for residential financing is the:

   A. Federal Home Loan Bank
   B. Federal Savings and Loan Insurance Corporation

C. Federal Savings and Loan Association
D. Federal Housing Administration

4. Our present monetary system is based on a

A. Gold standard.
B. Gold reserve standard.
C. Silver standard.
D. Standard of confidence.

5. The Federal Reserve System has powers to control the flow of money and credit in the United States. All of the following are included in these powers ***except***:

A. Establishment of the discount rate for member banks
B. Setting the reserve requirements for member banks
C. Setting the margin requirements on security purchases
D. Control over the sale and purchase of municipal bonds and their interest rates

6. Business cycles have four phases which are:

A. Prosperity, recession, depression, recovery
B. Depression, recession, obsolescence, recovery
C. Progression, recovery, reaction, depression
D. Obsolescence, depression, recovery, stagflation

7. When a business cycle begins to pick up after a downturn, this phase is called:

A. Property
B. Recession
C. Depression
D. Recovery

8. "Stagflation" refers to:

A. Inflation during an economic slowdown
B. Inflation during prosperity
C. A decrease in inflation during recession
D. A decrease in inflation during prosperity.

9. All of the following regarding the Federal Reserve System are true, except:

   A. There are seven regional banks
   B. The board of governors consists of seven members
   C. Each governor is appointed for a 14 year term
   D. It was created by an act of congress

10. When the Federal Reserve tightens up the money supply:

   A. The housing market is the last to feel the pinch
   B. Housing sales increase
   C. The use of seller carry–back financing declines
   D. Mortgage interest rates usually increase

Answer Key: 1–A, 2–D, 3–C, 4–D, 5–C, 6–A, 7–D, 8–A, 9–A, 10–D

CHAPTER 3: INSTITUTIONAL LENDERS

PREVIEW

The objective of this chapter will be to explore the traditional as well as some of the non–traditional sources of real estate finance. In this chapter we will talk about the meaning of institutional lender, the relative impact of these principal lenders in the real estate financing and what influences the lending policies of California real estate lenders.

INSTITUTIONAL LENDERS

An institutional lender is a lender that meets the following two criteria: (1) the lender is highly regulated by either federal or state agencies and, in some cases, by both agencies; and (2) it is an institution or depository that pools funds from individuals and/or companies and reinvests these funds in some type of securities, such as real estate loans. In other words, an institutional lender uses its deposits, or income, to make real estate loans. They generally perform as a financial intermediary as outlined in Chapter 2.

There are several major types of institutions which participate in mortgage finance: *commercial banks*, *mutual savings banks, savings and loan associations*, *life insurance companies, private pension funds*, *public pension funds, mortgage companies (mortgage bankers or brokers*), *real estate investment trusts, federal credit agencies*, and *mortgage pools*. These institutions may be private, governmental, or quasi–governmental. Private individuals become important as (non–institutional) lenders when interest rates are high and alternative or junior financing is necessary to secure property transfers.

COMMERCIAL BANKS

The forerunners of today's banks were first established in the Colonies in the 1660s. Banks have historically focused on commercial lending–that is, lending for commerce and industry–and residential mortgage lending has generally been a relatively small activity.

A ***commercial bank*** functions as a depository for funds and a place from which to borrow money. They are not to be confused with **"**industrial banks**"** or so–called finance companies. Commercial banks have two different forms of deposits, demand deposits and time deposits. The bulk of their funds are in ***demand deposits***, which are deposits in business and personal checking accounts. Rarely are such funds used for long–term mortgage lending, due to the highly volatile nature of such funds–that is, they may be withdrawn on demand by the depositor and therefore cannot be depended on to remain in the account for very long. For this reason they are also referred to as transaction money or transaction accounts.

- **Type of institution** – Depository financial intermediary.
- **Time deposits** or *interest–bearing savings accounts*, provide the bank with long–term funds that are invested into a variety of outlets, including real estate financing. Commercial banks may make almost any type of loan on virtually any type of reasonable collateral. Although their primary function is to make short–term business loans, California banks are aggressive players in the home loan market.
- **Organization** – Commercial banks are stockholder owned and subject to federal corporate income taxes. They may be chartered under either federal or state laws. Federally chartered or national banks are regulated by the Comptroller of the Currency, must be members of the Federal Reserve System (Fed), and have their deposits insured by the Federal Deposit Insurance Corporation (FDIC). State chartered banks may elect to belong to the Fed, in which case they are regulated by the Fed; or they may be insured and regulated by the FDIC. A few state chartered, non–member banks are regulated under state laws. Banks range in size from under $5 million in assets to over $100 billion.

- **Types of loans** – Commercial banks provide the most significant aid to housing through construction period loan–funds advanced during construction and prior to permanent mortgage financing. Banks routinely account for over 40% of home construction loans, and the majority of apartment project loans.

  Commercial banks are a primary source for short–term construction financing, when the builder or developer has a "take–out" commitment from some other lender–most often a savings bank–for the permanent mortgage loan following completion of improvements. Large commercial banks play a major role in financing business and commercial properties, while some smaller ones deal largely with home loans.

  Banks may make home loans up to 95% loan–to–value ratio, for as long as 30 years on single–family dwellings. Many banks require private mortgage insurance on loans whose ratio of loan–to–value is in excess of 80 percent.

  Banks make ***swing loans,*** sometimes referred to as ***bridge loans,*** which are short–term ***interim loans*** used to bridge the time during which a property remains unsold. For example, if you as home–owner purchase a replacement house before selling the first house, a swing loan would provide the funds to fill the gap until the sale proceeds provide the funds to pay off the loan. In short, you found the right house at the right price, but haven't sold your existing home, so you secure a loan to purchase the replacement dwelling, with the loan to be repaid as soon as the existing house sells. The lien may exist on both the old and the new homes. Swing/bridge loans may have monthly payments or may be set up to be paid in a single lump sum upon sale of the old home.

SAVINGS BANKS (FORMERLY S&LS)

A ***savings bank*** is a *financial intermediary* that accepts savings from the public and invests these savings principally in real estate trust deeds and mortgages. Previous called Savings and Loan Associations, most changed their name after the S&L crisis of the 1980s. Today they are frequently referred to as ***"thrift institutions."***

- **Type of institution** – Depository financial intermediary, together with Mutual Savings Banks (discussed below), they are classified as "thrifts".

- **Organization** – Savings banks may be either stockholder or mutually owned, and chartered under either state or federal laws.

- As a mutual institution, depositors and borrowers are given share certificates or receipts in return for deposits of money. This is why a deposit in a mutual thrift is often referred to as *a share liability* rather than *a savings deposit*. A capital stock institution, on the other hand, issues shares of stock to its investors, representing fractional shares of ownership of the institution.

S&Ls vs. Commercial Banks

Current legislation (1) allows savings banks to handle checking accounts and make a variety of personal consumer loans; (2) permits both commercial banks and savings banks to pay interest on checking accounts; and (3) eliminates the interest–rate differential between regular passbook accounts in thrifts and in banks.

Federal Chartered or State Chartered

Savings banks are members of the Federal Home Loan Bank system, are regulated by the FHLB Board, and must have their deposits insured by the FSLIC. State charters may be covered by FSLIC insurance (about three–quarters of them are, and all in California are insured); others may be insured by state funds. Savings banks may be grouped together with controlling stock interest held by a holding company; singly or in groups, they may form service corporations which are allowed to carry out both investment and traditional service functions.

To the saver or borrower, however, there is little difference between state and federal institutions, so similar are the laws and regulations under which they operate. They have substantially **"**parallel authority,**"** which means that home buyers can shop for loans almost anywhere.

Characteristics of Savings Banks (Thrifts)

Recent Developments of Saving Banks from S&Ls

- **Deregulation of Saving Banks** – Restrictions on the types of savings accounts could offer have also been eased, and the 1982 financial institution reform legislation vastly expanded their available services and savings offerings, enabling them to compete with less restricted credit market investments.

Because of economic difficulties and the 1982 reforms, S&Ls experienced a great deal of crisis and are changing dramatically.

- Mergers between thrifts, both inter– and intra–state, have reduced their number and created a few very large institutions. This has occurred both in rescue of troubled institutions, and to gain the financial size to take advantage of new asset and service powers.

- Thrifts now have the power to offer commercial and consumer loans and make a variety of other investments directly or through their service corporations. Tax laws still require heavy mortgage investment for the special deduction, but the new powers imply a reduced home loan emphasis in the future.

- Financial deregulation during the 1980s freed S&Ls to participate in most of the activities traditionally limited to commercial banks. Some S&Ls now use the term “bank” in their names. Some people see the commercial banks and the S&Ls essentially merging into one type of institution. However, the 1989 thrift industry “bailout” legislation has re–established many regulations for S&Ls.

- Government regulations require that a majority of their assets must be in real estate. Business and consumer loans are permitted to a limited extent but pale when compared with loans secured by real property.

  As a general rule, most home loans do not exceed 95% of the appraised value or sales price of the home, whichever is lower. Exceptions include government–backed loans, such as FHA and DVA. Most thrifts limit the maximum amount on a single loan to 1% of their total assets. Hence, larger thrifts are able to accommodate large loan requests more readily than smaller savings banks.

- Most thrifts limit their loans to 30 years, although 40–year loans are permitted in some cases. Fifteen–year loans are also widely promoted, especially in the home refinancing market. Sometimes, during periods of rising interest rates, many of these loans include provisions for due dates (balloons) in as few as three to five years, or for rollovers thereafter at the prevailing market rate. These have monthly payments amortized for 30 years, but the unpaid balance is due in three, five, or seven years.

- Interest rates in the past were highest among the Institutional real estate lenders. This was due to the large demand for loans and to the higher risks associated with higher *loan–to–value ratios.* (High loan–to–value means that the amount of the loan is high in relation to the appraised value or sales price of the property.) Currently, rates charged by commercial banks and savings banks are basically the same.

- Their basic real estate lending is on single–family, owner–occupied dwellings, but in a favorable market thrifts wilt also finance mobile home loans, non–owner–occupied dwellings, apartments, and commercial and industrial properties.

- Combination loans are often available. Such loans combine construction (short–term financing) and *take–out loans* (long–term or permanent financing) into one loan.

- Savings banks are permitted to make collateral loans secured by the borrower's savings accounts, savings certificates, bonds, existing secured notes, and certain other forms of readily liquid assets.

☞ ***Savings and loan institutions get most of their funds for real estate loans from individuals saving.***

TRENDS IN THE SAVINGS BANK INDUSTRY

Increased competition from commercial banks and mortgage companies, combined with imbalances between money–scarce and money surplus areas that create demands for multiregional lending programs, have contributed to the loss of stature of savings banks (thrifts) as the principal source of home loans.

MUTUAL SAVINGS BANKS

Mutual savings banks have been in existence since the early 1800s for the primary purpose of promoting individual thrift. They fall between commercial banks and savings and loan associations in their investment policies. They have greater asset flexibility than the S&Ls and have reduced their lending for residential mortgages in recent years. Nonetheless, they remain the third largest lender group in residential mortgage holdings, behind S&Ls and commercial banks.

- **Type of institution** – Depository financial intermediary, together with S&Ls are classified as "thrifts".

- **Organization** – Mutual savings banks operate much like former savings and loan associations, but they exist chiefly in the northeastern United States. None exist in California.

LIFE INSURANCE COMPANIES

Life insurance companies sell insurance policies and annuities and use the premiums paid plus reinvested dividends for investment.

Life insurance companies are another important source of real estate financing, particularly for commercial properties, such as shopping centers and office buildings. They are also a major source of credit for large apartment house projects, hotels and motels, industrial buildings, and regional shopping malls.

- **Type of institution** – Financial non–depository intermediary.

  A life insurance company is a firm that specializes in the insuring of lives for specified amounts in exchange for specified premium payments. The premiums are invested until such time as funds are needed to pay claims or to establish reserves for losses. These premiums are invested in many outlets, including trust deeds and mortgage loans.

- **State chartered** – Life insurance companies are chartered by states and operate under the insurance laws of the states in which they operate. They may be organized as either corporate or mutual companies.

- **Mechanism** – Payouts to policyholders take the form of benefits, which are reasonably predictable based on mortality tables, and policy loans. Life insurance companies generally seek out the best yields consistent with their cash flow needs and have no basic commitments to residential mortgage investments. Loan originations most commonly take place through mortgage bankers rather than directly.

- **Role in Mortgage Market** – While investment in residential mortgages by life insurance companies has been declining, they are an important source of funds for large, multi–million–dollar apartment and commercial projects.

They also make significant purchases of mortgage–backed securities guaranteed by the GNMA. Life insurance companies are also important to non–residential mortgage lending.

CHARACTERISTICS OF LIFE INSURANCE COMPANIES

The chief lending characteristics of life insurance companies include the following:

- The average cost of funds to life insurance companies is generally lower than the cost of funds to the S&Ls because dividends to participating policyholders are usually paid at a lower rate than the interest paid on savings accounts.
- Life insurance companies are less concerned with liquidity than with the safety and long–term stability of an investment. Therefore, they display a propensity to finance the larger real estate projects, leaving the smaller loans to other lenders.
- Loan–to–value ratios are apt to be on the cautious side, frequently less than 80 percent.
- Life insurance companies have the broadest lending powers of the Institutional lenders. Their investment policies are flexible and cover a wide range of financing activities. The laws governing life insurance companies' activities vary from state to state.
- Under California laws and regulations, any company not incorporated within this state, but doing business here, is subject to the same restrictions that are placed upon California–based companies.
- Payback terms are long, usually 30–year amortizations, with occasional lock–in clauses that prevent a loan from being paid off before a specified date. For example, there might be a 10– or 15–year lock–in clause on a 30–year loan.
- Interest rates and other fees on conventional loans have traditionally been the lowest among the institutional, though in recent times they have been steadily climbing.

- Insurance companies prefer to grant large real estate loans (in the millions) as opposed to smaller residential home loans. Many major commercial and industrial developments have insurance company take–out loans.

- Construction loans generally are not desired. Instead, life insurance companies will make the take–out, or permanent, loan after the structure has been completed according to plans and specifications.

- Loan correspondents, such as mortgage companies, are widely used as agents of insurance companies. Many life insurance companies will contract for such representation whenever they deem it profitable. In this way the insurance company is relieved of the burden of originating and processing loans, as well as some administrative and service functions. Correspondents are especially used in California, where there is a high demand for loans, but where few insurance companies are actually headquartered. Detailed information concerning lending authority for insurance companies is found in the California Insurance Code.

PENSION AND RETIREMENT FUNDS

Like life insurance companies, pension and retirement funds use mortgages and mortgage–backed securities as a vehicle for investing their reserves.

Pension and retirement funds has become potentially the largest sources of real estate financing**.** There are hundreds of thousands of private pension funds and state, local, and federal pension funds nationwide, representing over $1 trillion in assets. The Mortgage Bankers Association of America projects the growth of these funds will create an enormous amount of potential mortgage funds that could become available to prop up housing and other real estate markets.

CHARACTERISTICS OF PENSION FUNDS

- **Organization** – Pension funds are classified as either private or public, according to the nature of the contributing employer. Private funds are regulated by the Employee Retirement Income Security Act of 1974 (ERISA), and public funds by their respective state laws.

- **Type of Institution** – Financial non–depository intermediary.

  While public pension funds have invested to a considerable degree in mortgages, partly for political reasons, private funds, in spite of their greater size, have not. In part this is due to the ERISA restrictions which are intended to protect the funds of pensioners. The Department of labor now allows such funds to invest in securities backed by pools of mortgages where the securities are issued or guaranteed by GNMA, FHLMC, or FNMA. Private issues of mortgage–backed securities are also qualified investments under certain restrictions, as are individual loans.

According to a survey by the American Society of Real Estate Counselors, domestic pension funds are the leading source of direct investment funding for institutional–qualify office buildings in the 1990s.

- **Role in the Mortgage Market** – Pension fund investments have increased as a result of the ERISA exemptions. Nonetheless, mortgages and securities must be competitive with other investments to attract sizeable amounts from pension funds.

Individual Retirement Accounts (IRAs) and Keogh Plans

As private pension programs became more popular with liberalized tax–deferred contributions for Individual Retirement Accounts for employees, and allowances under the Keogh Plan for self–employed persons, substantially more of these dollars are entering the capital markets. These funds are an important source of real estate financing on all levels. New money is being brought into the capital market from employers, employees, and the self–employed in what might be viewed as a captive market, since the steady inflow of such funds is often more stable and dependable than savings inflow into thrift institutions. (Pension funds accumulate until each member reaches retirement age, whereas savings strictly as time deposits are more volatile.)

Until recently, most pension funds had been invested in government securities and in corporate stocks and bonds. However, the rapid increase in the assets of pension funds and the desire to diversify these investments are causing some fund managers to look at real estate loans as an additional source for investment.

Chapter Quiz

1. Short–term loans are preferred by:

A. Savings and loan institutions
B. Commercial banks
C. Insurance companies
D. Pension plans

2. Mortgage bankers would likely:

A. Use their own funds to make loans
B. Sell loans to investors
C. Service the loans they have sold
D. All of the above

3. Savings and loan institutions get most of their funds for real estate loans from:

A. Borrowing from the Federal Reserve
B. Stockholder equity
C. The sale of bonds
D. Individual savings

4. All of the following are Institutional lenders ***except***:

A. Mortgage company
B. Commercial bank
C. Savings bank
D. Life insurance company

5. Which lender typically specializes in construction loans?

A. Life insurance company
B. Mortgage company
C. Savings bank
D. Commercial bank

6. A homeowner would least likely obtain a small equity loan from a/n:

A. Insurance company
B. Small loan company
C. Credit union
D. Commercial bank

7. Which class of lenders experienced the greatest “crisis” in the 1980s?

A. Commercial banks
B. Mutual savings banks
C. Life insurance companies
D. Savings and Loan associations

8. Insuring the deposits of commercial banks and savings banks is the

A. Office of Thrift Supervision.
B. Savings Association Fund.
C. Federal Home loan Mortgage Corporation.
D. Federal Deposit Insurance Corporation.

9. Which Institutional lender favors very large commercial property loans?

A. Savings banks
B. Credit unions
C. Life insurance companies
D. Savings banks

10. The bulk of funds held by commercial banks is in the form of

A. Certificates of deposit (CDs).
B. Cash.
C. Demand deposits.
D. Securities.

Answer Key: 1–B, 2–D, 3–D, 4–A, 5–D, 6–A, 7–D, 8–D, 9–C, 10–C

CHAPTER 4: NONINSTITUTIONAL LENDERS

PREVIEW

In previous chapter, Institutional lenders were described as real estate lenders whose activities are highly regulated by various state and federal agencies.

In this chapter you will study noninstitutional lenders – real estate lenders whose activities are not as strictly regulated as Institutional lenders. Noninstitutional lenders, also called nonfiduciary financing include *private parties, mortgage companies, syndicates*, *real estate investment trusts*, *pension and trust funds*, and *credit unions*.

SEMIFIDUCIARY AND NONFIDUCIAY LENDERS

The second general source of funds for real estate finance is a group known as *financial semi fiduciaries.* This heterogeneous group is composed of real estate mortgage brokers and bankers, real estate mortgage and investment trusts, real estate bond dealers and endowment fund managers. Some semifiduciaries arrange mortgages between the major fiduciary lenders and borrowers. Others make direct loans using their own funds.

Unlike banks, savings institutions, life insurance companies, pension funds and credit unions, which are directly responsible to their depositors and premium payers, the semifiduciaries are removed from a first-person relationship. Although the *quality of a fiduciary relationship* is somewhat implicit in their actions, the semifiduciaries' responsibilities are directed either internally, to their owner-partners, or externally, to the primary fiduciaries that they represent, but never directly to any depositors or premium payers. Although a semifiduciary is expected to invest entrusted funds with sound judgment, no guarantee is given that the money will be returned dollar for dollar, as is the case in a primary fiduciary relationship. The distinction is quite fine, but it allows the semi fiduciaries to take more risks than the primary.

Mortgage brokers and bankers usually arrange first real estate mortgages between borrowers and financial fiduciaries that reflect the latters' conservative underwriting requirements. The investment trusts may lend money on second or even third mortgages, which entail somewhat higher risks. Even in the first instance, however, the fiduciary responsibility is external, between the mortgage brokers or bankers and their client fiduciary institutions, while the primary fiduciary responsibility remains between the banks, savings associations and life insurance companies and their depositors and premium payers. In the second instance, the fiduciary responsibility is internal, between the managers of the trust funds and the trusts' owner-beneficiaries. Owners have chosen their manager on the basis 6f investment acumen, but no one has promised that every investment will be a success. The owners are willing to take some risks in order to earn high yields, and it is the manager's job to choose these investments wisely. This same fiduciary relationship also exists between real estate bond brokers and their clients as well as between the managers of foundation endowment funds and the funds' donors.

A final group of lenders that provides funds for real estate finance is generally described as *financial nonfiduciaries.* This group includes private loan companies and individuals. Little precise data are available about the overall impact of nonfiduciary lenders in the realty money market because of the relatively private nature of the participants' transactions. Because these nonfiduciaries invest their own funds in real estate finance, they owe no duty to others and can maintain complete discretion over their activities.

Despite this comparative freedom to make all final decisions, nonfiduciaries observe certain limitations. Nobody invests to lose money, so good underwriting practices must be followed. Nevertheless, of all the lenders in the field of real estate finance, the nonfiduciaries have the most flexibility and can take the most risks, which often makes them the only source available to finance certain real estate transactions.

PRIVATE LENDERS

Although the term private lenders in its broadest sense refers to virtually all non–government lenders, for our purpose a private lender means a person who lends directly to another person. This narrow definition will help to distinguish a private lender from the other forms of noninstitutional lenders discussed in this chapter.

4: NONINSTITUTIONAL LENDERS

There is no formal structure to the private lender industry. Individuals ordinarily do not operate in concert with one another. Private lenders have no association such as those found with other forms of lenders and are, at best, highly fragmented and scattered throughout California. An individual may, of course, form a partnership or a corporation, but these are mere business organizations designed to facilitate the operation of the individual's investments into real estate trust deed or mortgage loans.

Unlike Institutional lenders, private individuals have fewer laws and regulations that restrict their lending activities. There are no uniform policies; practices, procedures, and policies vary considerable from one private lender to another. However, individuals can be subject to the usury statutes that dictate the maximum interest rate that may be legally charged. Exemptions from the usury law are discussed later in this chapter.

TYPES OF PRIVATE LENDERS

SELLERS AS PRIVATE LENDERS

The single most important source of nonfiduciary finance funds consists of the sellers who finance a portion of the sales price with carry back loans. In fact, seller financing has become the only way many current sales can be consummated. Using junior loans, land contracts, wraparounds and other creative financing devices (will be described in later chapters), sellers frequently agree to help finance a portion of a property’s sale price rather than lost the deal.

Some loans made directly between buyer and sellers involve first deeds of trust, however, most individual financial agreements, involve junior financing instruments in which a seller carries back a portion of the equity in the property.

☞***A large number of private party loans are seller carry backs.***

PRIVATE MORTGAGE INSURERS (PMIS)

These are private businesses which offer mortgage insurance and mortgage–backed securities insurance. There are approximately 18 major mortgage insurers which are approved to insure mortgages to be purchased by FHLMC.

- Type of institution – Insurer.
- **Organization** – PMI's are corporations organized under state laws.

- **Purpose** – The bulk of the PMI business is the insurance of lenders against loss due to default on home mortgages. Most companies also insure lenders and investors against losses from commercial loans and leases, obligations of municipalities, and mobile home loans, and provide some casualty insurance. Increasingly, they insure the cash flow on mortgage–backed securities. The securities are backed by conventional loans, and most issuance are linked to tax–subsidized revenue bonds issued by states and municipalities.

- **Mechanism** – PMI's deal only with lenders approved by them. Insurance is usually written for home mortgages with loan–to–value ratios above 80 percent. The PMI covers 20 to 25% of lender losses on such loans. Even after the lender has approved a loan, the PMI Company may approve or reject the lender's decision or may make conditions to be met for the loan to be approved.

CHARACTERISTICS OF PRIVATE LENDERS

Private lenders generally have some common characteristics, regardless of whether the loan is made directly by the individual or indirectly through a loan broker:

- Most loans are on single–family dwellings because this type of property is most familiar to the typical private investor, and also because the size of the loan is relatively modest.

- The vast majority of loans by private individuals are made within the geographic areas most familiar to the lender.

- Private lenders are for the most part less formal, and therefore make highly subjective loan decisions, especially when making a loan directly to a borrower. On the other hand, mortgage brokers who represent private lenders are usually very sophisticated.

- High interest rates are normally charged, due to the high risks involved. However, exceptions exist in seller carryback transactions where a relatively low rate may be acceptable due to offsetting benefits. To compensate for, say, a 7% rate, a seller might either increase the price of the property or be willing to settle for the lower rate when the rates quoted on new first loans are so high that buyers are unwilling to pay high rates on the junior loan.

- Most private lenders operate in the second trust deed market. As pointed out previously, this is often created by the dictates of the marketplace, when a seller carries back a second deed of trust in order to close the transaction. Frequently these second loans are thereafter sold to investors, usually at a discount, when the seller needs cash.

- Private lenders rarely make prime loans and almost never get involved in construction financing. (Prime loans are those that involve the least risk to lenders and are usually first liens.)

- The term of a private loan is usually short and often calls for a balloon payment. Six months to five years are the most common maturities.

- Monthly collections are frequently performed through a mortgage company or financial institution, though individual lenders may in some cases collect themselves. The setup and collection fees charged by commercial and savings banks are relatively small, since these institutions are interested in obtaining the customer's account. Some offer free collection service when the customer maintains a minimum balance in a savings or checking account.

USURY LAW

Many states have passed laws establishing the maximum rate of interest that can be charged on various types of loans. Interest rates that exceed the maximum rate are considered usurious and therefore illegal. In some instances if a tender is found guilty of usury, the borrower would not have to pay any interest!

- **Maximum Rate** – In California the maximum rate for loans secured by real property is the greater of ***10%* or *5% above the Federal Reserve Bank discount rate***, unless the lender is exempt from the law.

- **Exemptions** – California regulations exempt from the usury law Institutional lenders such as banks, thrift institutions, and life insurance companies. Also exempt from usury laws are noninstitutional lenders including *mortgage companies, credit unions, personal property brokers*, *owners who carry back paper when they sell*, and any transaction that uses a real estate broker. However, direct private lenders are not exempt. For example, real estate loans from regulated Institutional lenders can be at any rate, whereas an actual direct hard money real estate loan (not a seller carryback loan) from a private lender is not exempt, unless a real estate licensee is handling the transaction.

MORTGAGE COMPANIES

Mortgage bankers, mortgage brokers, or mortgage companies are primarily representatives of the ultimate sources of money, such as life insurance companies, savings banks, trust or pension funds, or private parties. They are essentially money brokers who may or may not service the loans they originate.

These entities are not thrift institutions, nor are they depository institutions, but they do assist by bringing the borrower together with a lender and charge a fee for this service.

TYPES OF MORTGAGE COMPANIES

- **Investment bankers** – Investment bankers make a market for both new and seasoned mortgage–backed securities. These firms, called *securities dealers,* buy and sell securities from lenders and investors. Mortgage bankers, savings banks, pension funds, insurance companies, and mutual funds generally conduct their secondary market transactions with investment bankers.

- **Mortgage loan brokers** are in the business of locating borrowers and lenders, and arranging loans between them. As such the loan broker takes no risk of loss. Another distinction between a *mortgage banker* and a *mortgage (or loan) broker* is that mortgage bankers service the loans of the lenders that they represent, whereas loan brokers usually do not.

- **Mortgage bankers** differ from mortgage brokers in that the former generally are not third parties to a loan. They generally fund the loan with their own funds.

  Mortgage bankers are generally incorporated businesses that can make loans with their own funds or through a line of credit. The mortgage banker originates, finances **"***funds***"**, and closes loans secured by real estate and sells them to Institutional investors for whom the loans are thereafter serviced. While at times a mortgage banker might act in a broker capacity, particularly if the loan is for an amount beyond the capacity of the mortgage banker to fund, this would be the exception rather than the rule.

Many of the loans made by mortgage bankers are made for particular investors such as other lenders and pension plans. They will make the loans to meet the lending criteria desired by these particular investors. Much of their activities deal with out–of-state lenders and investors who desire to make long–term loans secured by California real estate. Because of the size of our real estate market, California mortgage bankers can assemble packages of trust deeds of significant value.

- **Mortgage Correspondent** – When a mortgage banking company represents a life insurance company, bank, thrift association, pension fund, or other lender, it is called a mortgage correspondent**.** It **"**corresponds**"** on behalf of its principals in dealing with prospective borrowers. The mortgage correspondent is paid a fee in exchange for originating, processing, closing, and servicing loans. The firm may be given exclusive territories, in which case the correspondent will be entitled to a fee, even if it had not actively solicited the loan; or it may be nonexclusive, in which case the correspondent is in effect in competition with the lenders that it represents. Whatever the type of arrangement, loan correspondents serve a very valuable function in real estate financing for lenders whose headquarters or principal offices are located great distances from the properties on which they make loans. Correspondents have been especially successful in the Far West, particularly in California.

  Although most mortgage companies act as correspondents in investing others' funds, there are many firms that invest their own funds exclusively. Another category of mortgage lender is a hybrid, both investing money into real estate trust deeds and mortgages for others in an agency or fiduciary capacity, and its own funds in the role of a principal.

Characteristics of Mortgage Companies

- Type of institution – Brokerage.

- Mortgage companies do not take deposits, but finance their operations through short–term bank loans, their own capital, and fees from sales and servicing. They routinely sell nearly all the loans they originate, and are minor holders of mortgage debt.

- In California, mortgage companies are licensed by the ***Department of Corporations***, and they are subject to lending and other general business regulations.

- Mortgage companies may also engage in a number of related real estate activities. These include brokerage, development, construction, and property management. This is especially true when activity in the mortgage market slows down.

SYNDICATION

A syndicate is an organization of investors pooling capital for real estate investment. Syndicates can take the form of a corporation, a full partnership or, the most popular, a ***limited partnership***. A typical syndicate combines the money of the individual investors with the management expertise of a sponsor, known as the general partner, and follows a three step cycle: acquisition, operation and disposition.

In California, the Department of Corporations regulates control of syndicates. Under the Corporation's Code, real estate brokers may engage in the sale of real estate syndicate security interests without obtaining a special broker–dealer license. However, all such sales must be made under strict adherence to the full disclosure provisions of the California Uniform Partnership Act. In addition, the California Corporations Code, Section 15507, states that a limited partner may become liable for the *total* debts of the partnership if the limited partner takes an active role in management.

Syndicates are considered to be investment conduits that pass profits and losses to investors in proportion to their ownership shares. Any tax liabilities are imposed at the investor's level. Intrinsic in the design is the investors' liability for debts of the partnership, which are usually limited to their investment. The income from these syndicates, or limited partnerships, is considered passive by the IRS.

In the 90's, a new form of business organization, a ***limited liability company***, or **"**LLC,**"** was introduced which combines the single–level tax benefit of a partnership with the organizational structure and limited liability of limited partnerships and corporations. Members of an LLC can participate in running the organization without becoming personally liable for business obligations.

In California, an **"**articles of organization**"** form must be filed with the Secretary of State to establish an LLC. The LLC format may incur higher fees and taxes than general or limited partnerships
Corporate bonds are credit instruments used to raise long–term funds. When these bonds are backed by a mortgage on specifically described real

REAL ESTATE INVESTMENT TRUSTS

Real Estate Investment Trusts (REITs) are trusts, owned by shareholders who can exchange their shares on the open market. REITs provide a means by which relatively small investors can participate in large–scale real estate investments. REITs are very heavily invested directly in real estate.

REIT is a creature of the federal tax law. It was created in 1960 with the goal of encouraging small investors to pool their resources with others in order to raise venture capital for real estate transactions. It has been called the ***"mutual fund"*** of the real estate business. Just as mutual funds invest in a diversified portfolio of corporate stocks and bonds, REITs invest in a diversified portfolio of real estate and mortgage investments, with a large number of investors who combine or pool their funds.

REITs are conduits for investment income only. They are organized under state law as unincorporated associations managed by trustees. They are creatures of federal tax law which permits their distributions to shareholders to be nontaxable to the trust, so long as certain requirements are met. They provide a means by which relatively small investors can participate in large–scale real estate investments.

- **Requirements** – Briefly, at least 90% of ordinary income must be distributed to shareholders; more than 75% of assets must be real estate and more than 75% of income must come from such investments; there must be 100 or more shareholders with no fewer than six owning more than half the trust; the trust may not hold property for sale to customers in the ordinary course of business or provide services to tenants except through independent contractors.
- **Tax treatment** – REITs are tax–exempt only on the income passed through, and shareholders must pay personal income tax on that. Passthroughs of depreciation may offset ordinary income and passthroughs of capital gains do receive capital gains treatment. Under the Tax Reform Act of 1986, profits and losses are classified as "passive" income, putting limitations on the deductibility of ordinary losses.

During the economic crisis of the 1970s, many REITs folded under the pressures of poor management, excessive speculation, withdrawal and cancellation of take–out commitments, terminations of bank lines of credit, poor credit analysis, excess building in many parts of the country (particularly in the condominium market and in recreational projects), and sagging demand.

In the 1980s, to restore confidence in the REIT, concessions worked out between REITs and the banking and securities industry slowly revived REITs. This slow revival continued until the late 1990s, when a hot stock market put a damper on REITs. By 2001, the stock market declined and some money began to flow back into REITs.

MORTGAGE POOL

The "mortgage pool" category is unlike the others in that it is not a type of institution but refers to mortgages grouped together as backing for marketable securities. The securities are held, in theory, by institutions from the other lender groups. Because of the large proportion of securities held by "nominees" on behalf of investors, it is not possible to apportion the pools accurately to individual investors. Pools are generally handled by trustees for the issuers, and their existence depends upon the insurance or guarantees of one of the three federally–related mortgage corporations.

CREDIT UNION

A ***credit union*** is a mutual, voluntary, cooperative organization of people who agree to save their money together and to make loans to each other. It is organized by members of a particular group, most commonly by coworkers through occupational or professional affiliation. There are credit unions throughout the United States, representing many millions of members.

Under the 1980 Depository Institutions Deregulation and Monetary Control Act, credit unions are empowered to make all types of loans and to accept all kinds of deposits. As a result, they have expanded their coverage of the financial market and offer a wide range of real estate loans to their depositors–members, often at below–market interest rates.

For the most part, credit union lending in real estate has been short term. Some attempts at long–term loans have been tried and in some areas of California are working.

TYPES OF LOANS

Most mortgage bankers deal primarily in residential loans, the majority of which is single–family dwellings. However, some mortgage bankers handle a variety of property and might specialize in large commercial or industrial loans. They work with lenders who desire the highest interest possible from this type of loan.

SERVICING LOANS

Mortgage bankers generally want to service the loans they make and resell.

Servicing loans means doing the accounting necessary for a loan. The one–quarter percent to one–half percent service fee can be a significant profit center for the mortgage banker when thousands of loans are serviced.

With today's computer–servicing programs, servicing loans is no longer the labor–intensive activity that it was just two decades ago. Errors in computations have been virtually eliminated.

An advantage of servicing the loans is the control of impound accounts for taxes and insurance when it is collected in advance with loan payments. These funds, when deposited in a bank give a mortgage banker tremendous clout when they are borrowers from banks holding such funds. They are able to borrow funds at extremely attractive interest rates.

SPECULATING

Mortgage bankers, like commercial bankers, speculate on interest rates. If a mortgage banker believes that interest rates will rise, the mortgage banker will want to resell loans in the shortest possible time. Should rates rise, the value of loans held at below–market rates of interest will fall. Such loans will have to be sold at a discount from face value unless the mortgage banker has a firm purchase commitment from an investor.

> ☞ ***If a mortgage banker believes that interest rates will fall, he or she will want to hold as large a loan inventory as possible.***

The mortgage banker might not want to enter into firm agreement for the resale of such loans. If rates do fall, the higher interest mortgages will be more valuable on the secondary mortgage market and should sell at a premium to face value.

MORTGAGE WAREHOUSING

Some lenders want huge dollar packages of mortgages. One reason is that they might wish large packages in order to issue mortgage–backed securities. At other times, mortgage bankers might be speculating on falling interest rates which means the bankers will have a great deal of their own funds and borrowed funds tied up in loans.

SCOPE OF MORTGAGE BANKERS

Mortgage bankers borrow from commercial banks using their mortgage inventory to obtain additional capital for loans (loans secured by other loans are *collaterally secured*). There is a risk in mortgage warehousing in a movement of interest rates contrary to expectations. If rates fall, the mortgage banker would have a large inventory of loans which has to be sold at a price that could not only wipe out profits but be a financial loss.

PORTFOLIO LOANS

Portfolio loans are loans held by a lender as an investment. It is rare for a mortgage banker to tie up capital in a portfolio of loans. Lending is a capital intensive activity that requires a great deal of capital or the availability of such capital.

CONFORMING LOANS

Some mortgage companies make only conforming loans. They sell to savings and loans, thrifts and other lenders who want the ability to readily resell the loans should a sale be desirable.

The U.S. Congress sets the maximum loan amount on conventional loans purchased by Freddie Mac and Fannie Mae. The 2002 maximum for single–family loans was *$300,700*. Loans that meet these limits are called ***conforming loans****.* Interest rates for conforming loans are often lower than rates for nonconforming loans.

NONCONFORMING LOANS

In many areas of the United States, particularly in California, there is a high demand for loans that exceed these loan limits. These loans are commonly referred to as ***jumbo loans*** *or* ***nonconforming loans****.*

Mortgage bankers will only make a nonconforming loan when they either have a buyer for such a loan or know that a resale will not create a problem. Examples of such loans would be larger residential loans which exceed Fannie Mae and Freddie Mac maximums.

Because of the demand, private corporations were formed to issue mortgage–backed securities backed by these loans. The corporations are usually subsidiaries of large financial institutions and operate in much the same manner as Freddie Mac and Fannie Mae. They purchase loans, put them into pools, issue securities, and sell these securities to investors.

MULTIPLE LENDERS

Mortgage bankers will at times put together large commercial loans as either the lender or loan arranger which is divided among several lenders. Sometimes the reason for such a loan is sheer size. Many lenders would shy away from a billion dollar commercial loan for a new mall, but they might like a piece of the action because of the desirable interest rate.

Mortgage bankers are often able to put together a consortium of lenders to handle such a loan.

Another multiple–lender loan is a ***piggyback loan,*** *where a single loan is divided into parts and the parts have varying degrees of risk.* As an example, assume a million dollar loan is sought on a project valued at $1.3 million. One lender might agree to take $700,000 of the loan as the bottom portion at 9 1/2 percent interest. A second lender might agree to take the top portion of the loan ($300,000) at 12 1/2 percent interest. It is like a first and second trust deed written as a single loan. The second lender is subordinated to the first lender.

CHAPTER QUIZ

1. Mortgage companies:

    A. Prefer loans saleable in the secondary money market
    B. Serve as temporary lenders
    C. Are representatives for sources of money other than their own, yet sometimes lend funds of their own
    D. All of the above

2. Mortgage companies arrange and supervise:

   A. Loans for construction
   B. Take–out (permanent) loans
   C. Neither A nor B
   D. Both A and B

3. In California, Mortgage companies are licensed by:

   A. Department of Real Estate
   B. Department of Insurance
   C. Department of Corporations
   D. Department of Consumer Affairs

4. When a mortgage banker establishes a line of credit with a commercial bank, the bank is acting as the mortgage banker's

   A. investor.
   B. correspondent.
   C. warehouse for funds.
   D. mortgage broker.

5. Real estate investment trusts are all of the following, except

   A. corporations.
   B. partnerships.
   C. investment conduits.
   D. owned by 100 or more investors.

6. The success of a mortgage broker depends upon all of the following, ***except***

   A. underwriting ability.
   B. the number of defaulted loans.
   C. continuing relationship with investors.
   D. continuing supervision of the loan.

7. Unsecured bonds are called

   A. Coupon bonds.

B. Registered bonds.
C. Insurance bonds.
D. Debenture bonds.

8. When a bond is paid from property taxes, it is a

A. Railroad bond.
B. Revenue bond .
C. General obligation bond.
D. Corporate bond.

9. The most popular organizational form of real estate syndication in California is the

A. General partnership.
B. Corporation.
C. Limited partnership.
D. Real estate investment trust.

10. An organized group of people who agree to save their money and to make loans to one another is called a

A. Syndication.
B. Credit union.
C. Pension fund.
D. Trust fund.

Answer Key: 1–D, 2–C, 3–C, 4–C, 5–A, 6–D, 7–D, 8–C, 9–C, 10–B

CHAPTER 5: GOVERNMENT PARTICIPATION & BACKED LOANS

PREVIEW

In this chapter we will first examine the mortgage insurance programs of the Federal Housing Administration. In addition to these FHA programs, we will examine the guaranteed programs offered by the government: the Federal Housing Administration (FHA), U.S. Department of Veterans Affairs, and state Cal–Vet loans and other federal and state programs.

THE FEDERAL RESERVE SYSTEM

One of the most powerful government agencies in the United States, the "Fed" has a major influence on the economy and greatly affects the real estate market, through its control of monetary policy.

PURPOSE

The Federal Reserve was created with the specific purpose of reducing the risk and severity of financial crises, by regulating the flow of money and credit in the United States. This in turn promotes high employment and economic growth, and stabilizes the value of the dollar. The Fed monitors member banks and their liquidity. It also seeks to control the rate of inflation.

The system is composed of twelve Federal Reserve districts, each with a Federal Reserve bank. With the Fed having not a central bank, but district banks located throughout the United States, it can better respond to the different economic needs of the various areas of the nation.

Many of the Federal Reserve Banks also operate Federal Reserve Branch Banks or offices to further break down the districts and to better serve the financial needs of the individual districts.

The names of the Federal Reserve Banks and their branches, if any, are shown in figure below.

Figure 5-1: Federal Reserve Banks

1	Boston	7	Chicago – Detroit
2	New York – Buffalo	8	St. Louis – Little Rock – Louisville – Memphis
3	Philadelphia	9	Minneapolis – Helena
4	Cleveland – Cincinnati – Pittsburgh	10	Kansas City – Denver – Oklahoma City – Omaha
5	Richmond – Baltimore – Charlotte	11	Dallas – El Paso – Houston – San Antonio
6	Atlanta – Birmingham – Jacksonville – Miami – Nashville – New Orleans	12	San Francisco – Los Angeles – Portland – Salt Lake City – Seattle

Board of Directors

The Federal Reserve Banks are not under the control of any government agency, but each Reserve Bank is under a board of directors, composed of nine members who represent business, the banking industry, and the general public in their Federal

Reserve district. The directors are classified as A–, B– or C–class directors. Class A members can, come from the banking community of the district, class B members can represent the borrowers of the district, and class C Directors will represent the general public. Class B and class C directors cannot be connected to the banking industry in any way, including the owning of bank stocks.

The members of the board are primarily chosen by the banking community in the district. Class A and class B directors are elected by the member banks, and the selection process sees that all sizes of banks are represented. Class C members are selected by the board of governors of the Federal Reserve.

As in any other corporation, the board of directors selects the president and the vice–president, and the board of the Reserve bank will choose the members of boards of any branch bank established in their district. This process ensures that the branch banks reflect the needs of the areas they serve.

BOARD OF GOVERNORS

The board of governors has supervisory control over all of the Reserve banks throughout the system. The members are appointed by the President of the United States with the advice and consent of the Senate. The board is composed of seven individuals who each serve for a term of 14 years. These appointments are staggered so that only one term expires every other year. In order for the board to be truly representative of the whole system, the President tries to appoint only one member from each district.

The board publishes the *Federal Reserve Bulletin,* a monthly publication that gives information on the state of the economy in the nation and the world. The board also publishes reports on studies or research done for or under the authority of the Fed. One of the important groups of figures released each week by the Fed is **“**Federal Reserve Data.**”** These figures reflect the changes in the weekly averages of member banks' reserves and other related items. These weekly figures also report any change in the U.S. money supply.

The board can set the interest rate that member banks will have to pay when borrowing monies from the Fed. This rate is very important to the real estate industry because banks use this rate to establish the base rate (the rate their most creditworthy customer would pay). The base rate is usually the basis for the cost of builders' interim funds and for the rate for car loans and business operations loans. Due to recent litigation, many banks are abandoning prime rates for base rates.

The board may raise or lower the reserve requirements of the member banks. This requirement will affect the amount of money the banks will have available to ban: the lower the requirement, the more money the banks will have for loans: the higher the requirement, the less money the banks will have for loans.

Money Supply

The Fed provides an "elastic" currency supply (adjusts the money supply) within the United States. The Fed regulates the flow of money and credit by affecting their availability and cost. This is accomplished primarily through the exercise of three specific powers:

- Reserve requirements for banks
- Fed discount rate adjustments, and
- Federal Open Market Committee operations.

Member Banks

How does a bank become a member of the Federal Reserve System? Any national bank must belong, and any state bank that wishes may join. For a bank to join, it must buy stock in the Federal Reserve Bank System, agree to abide by the rules of the Federal Reserve, and meet the reserve requirements established from time to time to meet the fiscal policy of the Fed.

For the past several years membership in the Federal Reserve has been on the decline. This decline has been of concern to many economists because the Fed will not be able to control the supply of money or the rate of inflation as effectively as it might if the majority of the depository institutions were members. Realizing this problem, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980, which was signed by the President and became law on March 31, 1980. This act comprises ten titles affecting many areas of operations of the depository institutions. One of the most important titles is Title I, which greatly strengthens the Fed's control over nonmember banks by requiring them to meet the reserve requirements set by the Fed. This requirement will be phased in over 8 years.

Open Market Committee

The implementation of the change of the money supply is the responsibility of the open market committee. The Federal Reserve open market committee is presently composed of 12 members; 5 of the members are chosen by the board of governors and the remainder come from the 12 Federal Reserve districts. With only seven members left to be chosen, you can see that not all of the banks get to choose a member singly. In fact, only the Reserve Bank of New York gets to choose a member by itself.

The committee members meet on a regular basis, usually the third Tuesday of the month in an unannounced location, to establish what action they should take to carry out the fiscal policy of the board. The decision they reach is not announced to the general public, but the decisions of the open market committee are published on a delayed basis in the *Federal Reserve Bulletin* to hinder speculation on government securities and the U.S. dollar. The decision is carried out through a small staff that operates within the Federal Reserve Bank in New York, If the decision of the committee is to increase the supply of money, a member of the staff contacts a dealer who is licensed to deal in government securities and the dealer is given a check, drawn on the U.S. Treasury, to buy government securities. The check is then deposited into a member bank, thus increasing the supply of money available to the banking system in general. If the decision is to reduce the money supply, the committee makes recommendations to the board of governors to increase the reserve requirements or take any other action they may deem necessary.

Measurement of the Money Supply

One of the most important functions of the Federal Reserve is to control the supply of money in the hands of the public, as well as the amount held in bank accounts, both demand–type accounts and thrift deposits. By knowing the amount of money in bank accounts the Fed can manage the money supply by either increasing or decreasing the amount of money in circulation.

The various form of money supply (M1, M2 and M3) have been discussed in Chapter 2.

The measurements are reported each week by the member banks and the resulting figures are published usually on each Friday. These figures are compared with the previous week and either an increase or decrease is noted. If there is an increase in M1 that exceeds the guidelines set by the Fed, the Fed can take measures to slow or halt the growth in this area.

How Does the Fed Control the Supply of Money?

Many experts disagree on the Fed's attempts to control the supply of available money. Some feel that the economy should be allowed to operate by the law of supply and demand, and others feel that the economy or the supply of money should be strictly regulated. The system that is used tries to seek the best of both worlds. The economy is allowed to grow within certain guidelines through the law of supply and demand, and if the growth rate exceeds those limits the Fed then steps in to slow things down by using one or more tools available to them. The major tools or combination of tools they may use are as follows:

1. Open market operations (for minor adjustments in the money supply)
2. Change in reserve requirements (for more radical adjustments)
3. Change in discount rate (for more radical adjustments)

Each member bank must set aside a certain percentage of its deposits in a reserve account. These reserves have a twofold purpose: (1) to have monies in reserve in case the bank finds itself short of funds to meet the demands of depositors, and (2) to control the amount of monies available to the bank for the purpose of making loans.

For example, if the reserve requirement is 5% and the bank opens a new account in the amount of $1,000, it will have to put 5 percent, or $50, into the reserve account, thus leaving $950 to use for loans and the operation of the bank.

How does the Fed use this tool? Let's assume the Fed feels that at the present time the economy is growing too fast and is feeding inflation and it wants to shrink the supply of money available to the banks. All it has to do is raise the reserve rate requirement, and the banks must then make deposits to their reserve accounts to meet the new requirement. For example, a small bank has deposits of $2 million and the reserve requirement is 5 percent. That means the bank has to have $100,000 on account with the Fed. Now the Fed feels that there is too much money to loan, so it doubles the reserve requirement to 10 percent. The bank must immediately double the amount of money on account at the Fed. This takes another $100,000 out of the hands of the bank and leaves it less money available to loan. This would not only be true for this small bank, but for all of the banks in the system, thus reducing the money available rapidly and in large amounts. We then go back to the law of supply and demand. With the supply reduced, the interest rate should increase and, it is hoped, the demand will slow.

Another tool available to the Fed is to change the discount rate–the rate the Fed charges its member banks to borrow money. Why would a bank need to borrow? Whenever a bank has more commitments due than it has in cash available, it can use monies in its reserve account with the Fed. If in doing this the balance in a bank's reserve account drops below that required by the Fed, the bank must borrow to bring it into compliance.

It's not surprising that some experts refer to the Fed as the **“Bankers' Bank”!**

How can the discount rate be used to control the economy? If it costs the banks more to borrow money, this cost will be passed along to the consumer in the form of higher interest rates, or if the rate is lowered, the consumer *should* get the benefit of lower interest rates.

There is a good example of how the use of increasing the reserve requirements and an increase in the discount rate can affect the economy. In the fall of 1979, the economy was in runaway inflation. Inflation was at an annual rate of 13 to 14% and the Fed felt that it had to do something quickly. So it raised the discount rate a full 1 percent, thus causing the interest rate to shoot up and cut the amount of money available. The real estate industry saw the interest rate on single–family loans go to 13 to 13.5 percent, if you could find a lender with funds to loan.

EFFECTS OF MONEY SUPPLY MANAGEMENT

These major tools of money supply management can be used by the Fed to cause either ***tight money*** or ***easy money**.* Tight money is the policy of the Fed that makes money expensive (high interest rates). This is usually a restrictive policy, with high discount rates and increased reserve requirements. Thus, the money supply is reduced and, usually, the demand remains about the same: business still needs money to operate and to buy raw materials for production; the demand for housing goes on, but usually at a reduced rate. With about the same number of people pursuing a smaller number of dollars, the interest rate increases until the demand starts to fall.

A good example of this policy happened during the third quarter of 1979 and continued into 1982, when the Fed instituted a strong tight–money policy to try to stop inflation and stabilize the dollar. During this time of tight money we also saw the mood of the world change toward the Fed. Most of the world felt that the Fed would not keep the tight–money policy due to the unpopularity of this policy and political pressures. They therefore thought inflation in the United States would continue to run wild. So the world turned to precious metals, and the price of gold and silver shot to all–time records. Gold sold for over $800 per ounce.

Even though the Fed came under attack, it continued its policy of tight money into 1982 and the inflation rate in the United States was reduced. Gold was less in demand, thus the price fell and gold was traded in the fourth quarter of 1981 in the $350– to $450–per–ounce range.

With the price of gold falling and interest rates staying relatively high due to the Fed's tight–money policy, the demand by foreign investors for the American dollar increased. Thus, the value of the dollar increased against many foreign currencies.

Easy money is just the opposite of tight money. The Fed's easy–money policy is to reduce the reserve requirements and lower the discount rate. This is usually implemented in a time of recession; the Fed uses this policy to stimulate the economy. It increases the supply of money, thus making it easier for business and individuals to get credit. As credit becomes available, companies can expand, hire more people, and increase salaries. As these monies go into the banks and thrift institutions, it tends to make more money available, and thus the cycle begins again.

How can these policies affect the real estate industry? In the second half of 1979, when the Fed started a tight–money policy, interest rates started to shoot up on builders' interim loans (those loans made to builders to construct homes), making the builders' costs increase, thus the cost of the houses went up. In some cases, the rates got so high that builders were forced out of business. Mortgage rates increased as the cost of funds to mortgage lenders increased. As the rates increased, many states were forced out of the mortgage market as rates reached or exceeded state usury laws. (Usury laws will be discussed later in this chapter.) These are only a few of the problems that can be brought about by a tight– money policy.

THE TREASURY DEPARTMENT

The government's balance sheet, just as in any company in the private sector, has to be monitored. In private enterprise, a company's board of directors provides direction as to the thrust of the company in the future. This direction is then spearheaded by the chief executive officer of the company. The quality of this direction is reflected in the performance of the staff and company profits.

The U.S. government's financial performance – creating sources of income (receipts) and directing the allocation of that income (expenditures) – is directed by the President who submits a budget for approval and the Congress of the United States which adopts the budget and approves expenditures. The budget is contained in the annual Economic Report of the President, usually published in January.

The U.S. Treasury Department handles the huge financing requirements to fund these budgetary allocations and adjust cash flow requirements during the fiscal year. The spending and taxing policy is referred to collectively as ***fiscal policy***. Funds are acquired by sale of debt instruments to the public in the form of obligations (bills and notes). The volume of financing required at a given time can severely impact the funds available for mortgage financing. As the level of government spending is reduced, more money is available for the private sector for capital expenditures such as real estate.

As fiscal agent for the federal government, the Treasury assisted in funding the origination of secondary market entities, such as Federal National Mortgage Association (1938) and Government National Mortgage Association. The resale market established by these agencies has provided the principal source of permanent loan funds for residential real estate.

Ostensibly, the Federal Reserve and the Treasury reached an accord in 1951 and pledged to coordinate their activities to create some degree of economic stability. Real estate lenders who, in the late 1970s and 1980s, saw permanent loan rates reach the 17% to 19% level and the national prime rate (now gradually being replaced by the generic base rate) attain a whopping 21% level, obviously feel that the two agencies merely give lip service to the accord.

A basic understanding of the forces at work affecting the supply of money and credit is important to the understanding of how the mortgage money market works. National and local factors in the lending area must be considered when making the underwriting (business) decision in granting a new real estate loan.

Federal Deposit Insurance Corporation (FDIC)

Under FIRREA (to be discussed in next section), the Office of Thrift Supervision (OTS) was formed to regulate the S&Ls. This had been handled by the Federal Home Loan Bank BOARD (FHLBB), which was eliminated by FIRREA..

The FDIC was granted initial responsibility for the Resolution trust Corporation (RTC), which was formed to liquidate the assets of fraudulent and failed S&Ls. By the time, this was complete, hundreds of S&Ls had ceased to exist.

The FDIC is appointed receiver or conservator for the purpose of reorganization or liquidation of failed banks and savings associations. When acting in either of these capacities, the FDIC is not subject to the direction or supervision of any other agency or department of the United States or of any state.

If a bank or savings institution fails, the FDIC can take any appropriate action to put the insured deposit institution in a sound and solvent position. The FDIC can appropriate funds to carry on the business of the institution and conserve its assets and property and may also, if necessary:

- Organize a new federal savings association to take over such assets or liabilities; or

- Merge the insured deposits of the failed institution with those of another insured depository organization.

- Place the insured depository institution in liquidation and proceed to dispose of its assets.

In the event of liquidation, the payment of insured deposits will be made by the FDIC as soon as possible, either by cash or by a transferred deposit into another insured depository institution.

FIRREA also eliminated the old Federal Savings and Loan Insurance Corporation (FSLIC), granting the FDIC permanent responsibility for managing the Savings Association Insurance Fund (SAIF), which replaced the old FSLIC in insuring savings banks (the new name for S&Ls).

☞ ***For more information on FDIC, please visit web-site:***
www.fdic.gov/bank/historical/index.html

FEDERAL HOME LOAN BANK BOARD

The Federal Home Loan Bank Board (FHLBB) is an independent federal regulatory agency which serves savings and loan associations in a manner similar to the way that the Federal Reserve System serves banks. It acts as the "banker's bank."

- **Origin and Structure** – The FHLBB was created in 1932. The United States is divided into 12 districts with a Federal Home loan Bank established in each district.

- **Purpose** – The FHLBB provides a credit reserve system for its members. Members can borrow funds on a long–term or short–term basis at the current discount rate, and pledge existing loans and trust deeds as security to borrow funds.

MEMBERSHIP

Both federal and state chartered savings and loan associations may belong to the Federal Home Loan Bank system.

- **Federal Savings and Loan Associations** – These were authorized by the Home Owners' Loan Act of 1933, which set the guidelines to obtain a federal charter.

- **State Savings and Loan Associations** – These are supervised by the State Savings and Loan Commissioner.

- **Structure of S&Ls** – Most S&Ls are corporations. Owners hold shares of stock. Stockholders' investments are used to pay operating losses but depositors' investments are not. There are also mutual organizations, in which depositors are the investors and owners, sharing expenses, losses and profits.

INSURANCE

- **The Federal Savings and Loan Insurance Corporation (FSLIC),** created by the National Housing Act of 1934, insures savings and loan associations as the FDIC insures banks.

- **Required for Federal S&Ls** – All federally chartered savings and loan associations are required to insure their accounts.

- **State S&Ls** – State chartered associations may join, providing they are FSLIC accepted by proving financial and management stability.

- **Premiums** – Savings and loan associations pay a premium for the insurance based on a percentage of their deposits.

- **Amount Insured** – All depositors' accounts are insured to $100,000.

THE FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT OF 1989 (FIRREA)

On August 9, 1989, FIRREA was signed into law to reform, recapitalize and consolidate the Federal Deposit Insurance system and to enhance the organizational and enforcement powers of the federal agencies regulating financial institutions. This action was taken in response to the failure of numerous savings and banking organizations and was an attempt to preserve the integrity of the U.S. banking system.

Under Title I, Section 101 of the Act, its purposes are enumerated as follows:

- To establish, under the Department of the Treasury, the Office of Thrift Supervision (OTS) to manage this nation's savings and loan institutions;
- To establish a new corporation, to be known as the Resolution Trust Corporation (RTC), to contain, manage and resolve failed savings associations; (This corporation has completed its task and has been dissolved as of December 31, 1995.)
- To promote the independence of the Federal Deposit Insurance Corporation from the institutions holding the deposits it insures by providing an independent board of directors, adequate funding and appropriate powers;
- To promote, through regulatory reform, a safe and stable system of affordable housing finance;
- To improve the supervision of savings associations by strengthening capital, accounting and other supervisory standards;
- To curtail investments and other activities of savings associations that pose unacceptable risks to the federal deposit insurance funds;
- To put the federal deposit insurance funds on a sound financial footing;
- To provide funds from public and private sources to deal expeditiously with failed depository institutions;
- To strengthen the enforcement powers of the federal regulators of depository institutions; and
- To strengthen the civil sanctions and criminal penalties for defrauding or otherwise damaging depository institutions and their depositors.

☞ ***For more information on FIRREA, please visit web-site: www.fear.org/menuidx2.html federal forfeiture Procedures/18 U.S.C.***

SMALL BUSINESS ADMINISTRATION

This agency through its involvement in the community reinvestment program and its ability to make disaster loans to home owners, can have an effect on the real estate market.

GOVERNMENT SERVICES AGENCY

This agency has the responsibility of overseeing the real estate and buildings of the federal government. It can affect the value of real estate in a given market by acquiring or disposing of land or buildings.

THE FEDERAL LAND BANK AND THE FARMERS HOME ADMINISTRATION

These are both active in the financing of farms, farmland, and rural housing.

FEDERAL MORTGAGE FINANCE SYSTEM

There are three agencies play an important role in the secondary market, they are the Government National Mortgage Association (GNMA), the Federal Home loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA).

The GNMA is a government agency; the FHLMC is a quasi–government agency; and the FNMA is a former government agency that became a private corporation in 1968. The function of these agencies is to support the secondary market (secondary market will be discussed in Chapter 7) through the purchase of loans or the guarantee of mortgage–backed securities issued by lenders. These agencies, along with other minor players such as the Federal Agricultural Mortgage Corporation, or Farmer Mac, and the Student loan Marketing Association, or Sallie Mae, are collectively known as government–sponsored enterprises.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA)

The Government National Mortgage Association, commonly called Ginnie Mae (GNMA) is a government-owned corporation created by the Department of Housing and Urban Development Act of 1968.

GNMA is the government agency, which participates directly in mortgage finance, as a guarantor of pool securities, and through management of loans under special subsidy program and the tandem plan.

Its basic mission was to create and operate a mortgage–backed security program for FHA and DVA mortgages. It took over duties formerly performed by FNMA, after FNMA was given private status.

PASS–THROUGH SECURITY

In 1970 Ginnie Mae issued the first security backed by a pool of FHA and DVA mortgages. It was called a ***pass–through security*** because the monthly principal and interest payments collected from the borrowers were passed through to the investor. Ginnie Mae does not purchase mortgages. Its function is to guarantee that principal and interest will be paid every month. Since it is a government agency, the guarantee is backed by the "full faith and credit" of the U.S. government. For this guarantee, Ginnie Mae receives a small fee from the lender, which is collected monthly. The minimum amount that can be placed in a pool is $1,000,000. The mortgages cannot be over one year old and must have met predetermined average yields for the pool of loans. The pool can contain any combination of FHA and DVA mortgages. The lender can apply to Ginnie Mae for a commitment to issue a certificate at any time. When applying, it must indicate the size of the pool and the rate of interest on the mortgages. If Ginnie Mae approves the request, it issues a commitment that is good for one year.

Before the certificate is sold, Ginnie Mae requires that the mortgages be in the hands of a third party. This party acts as a trustee for Ginnie Mae and is called the ***custodian***. The custodian is usually a bank, but it could be any federal or state financial institution acceptable to Ginnie Mae. The lender delivers the mortgage documents to the custodian, who checks the information carefully. Once the custodian is satisfied that it has all the documents, it notifies Ginnie Mae. The certificate is then issued to the lender.

With the certificate in hand, the lender is able to sell the mortgages to an investor. When the investor buys the mortgages, it receives the certificate. Typically, the securities are purchased by securities dealers who trade in Ginnie Mae securities. They in turn sell the securities to other investors such as insurance companies, pension funds, other lenders who need mortgages, and individuals. The securities can be broken down into smaller denominations to satisfy the demands of the various investors (the smallest denomination is $25,000). The securities are traded on Wall Street just like stocks and bonds. There is an active market for the securities, which makes them a liquid investment.

CHARACTERISTICS OF GINNIE MAE

- **Type of Institution** – Federal government secondary mortgage agency.
- **Former FNMA Functions** – GNMA handles special assistance loans (housing programs) and manages liquidation functions that were once part of FNMA.
- **Residential Secondary Market** – GNMA is able to purchase, sell, and manage residential mortgages.
- **Mortgage–Backed Securities** – GNMA guarantees securities authorized by FNMA when they are backed by FHA, DVA, and the Farmers Home Administration.
- **Special Assistance Functions** –GNMA carries out federal subsidy operations for particular types of mortgages (e.g., the "tandem" program, where GNMA buys from private lenders special mortgages which would not otherwise be made, to reduce mortgage payments for HUD's rental subsidy apartment projects). Similar operations have been carried out for homeownership subsidies, and to support the homebuilding industry during recession periods. Lenders wishing to sell such mortgages to GNMA must have a prior commitment and loans and borrowers must be approved under HUD program regulations.
- **Securities** – GNMA commits to guarantee, and guarantees securities representing interests in pools of mortgage loans underwritten by the Federal Housing Administration (FHA) and Veterans Administration (DVA), and the Farmers Home Administration. The mortgages in the pools must be similar in type and terms; pools may comprise standard, graduated payment, or growing equity loans, and other types are under consideration. The securities, or "Ginnie Mae" guarantees, are backed by the full faith and credit of the U.S. government.

☞***For more information on Ginnie Mae please visit web-site: www.ginnemae.gov***

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA) / FANNIE MAE

The National Housing Act of 1934 created a forerunner of The Federal National Mortgage Association (FNMA) in order to set up a secondary mortgage market. FNMA itself was formally established by Congress in 1938 provide a secondary market for mortgages. It remained a part of the federal government until 1968, when it became a private corporation. It is now a profit–making, tax–paying agency which raises capital and uses its funds to purchase conventional and government–underwritten mortgages, and transforms its mortgage pools to securities.

☞ ***FNMA stock is now listed on the New York Stock Exchange.***

Even though it is private, the corporation has a public purpose and maintains strong government ties. It is subject to some regulations by the Department of Housing and Urban Development (HUD). It also has the ability to tap the U.S. Treasury if necessary.

Fannie Mae issues a security backed by conventional loans and operates the issuance of its securities much like Freddie Mac. It buys mortgages from lenders, places them in a pool, and issues a security. The security is sold to investors, who receive a guarantee, that principal and interest will be paid monthly, whether or not payments have been collected from the borrowers. Fannie Mae charges a monthly fee for the guarantee.

Characteristics of Fannie Mae

The FNMA or **"**Fannie Mae**"** is the largest single mortgage investor in the country.

FNMA is a federally sponsored secondary mortgage market agency.

- **Secondary Market Role** – FNMA is the largest and oldest major secondary money market for mortgage notes.
- **Loans Purchased** – FNMA purchases existing FHA, DVA, and conventional loans, and makes advance commitments to purchase future loans.
- **Sale of Loans** – FNMA auctions loan portfolios (groups of loans) to investment groups and individuals.
- **Organization** – Stockholder owned, FNMA is headed by a 15–member board of directors, five appointed by the President of the United States and ten elected by stockholders. It is subject to policy supervision by the Department of Housing and Urban Development and regulation in credit markets by the Treasury. FNMA is authorized to borrow directly from the Treasury, but the authority has never been used.

- **Mechanism** – FNMA raises capital through issuance of stock, both common and preferred; sales of debentures and notes, which are classified under "federal agency debt" in credit markets, even though they are not debts of the government; fees from commitments and guarantees; and sales of mortgages and securities backed by pools of mortgages.

- The corporation buys mortgages, including first and second liens, fixed– and adjustable–rate loans, graduated payment and other types of loans. A federally mandated ceiling for home loans is adjusted annually in accordance with a house price index.

- **Commitment System** – Lenders wishing to sell mortgages to FNMA may do so "over the counter" at posted prices with mandatory delivery of the mortgages, or may obtain a "standby" or "convertible" commitment from FNMA to take the mortgages within a specified period. Since 1981, most commitments have been limited to one or two months. Commitments may be obtained at posted prices or by bidding for them at biweekly auctions.

☞ ***For more information on Ginnie Mae please visit their web site at www.fanniemae.com***

FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC) / FREDDIE MAC

The Federal Home Loan Mortgage Corporation was created by the Emergency Home Finance Act of 1970. FHLMC is owned by the 12 Federal Home Loan Banks to establish their own secondary mortgage market. It is the newest of the three government related agencies.

The FHLMC or "Freddie Mac" is another quasi–public entity, which transforms pools of conventional mortgages to securities.

Because Ginnie Mae included only FHA and DVA mortgages in its securities, there was a great need to develop a mortgage–backed security for conventional loans. In 1971, the Federal Home loan Mortgage Corporation, also known as Freddie Mac, introduced the first security backed by conventional loans. Freddie Mac is a subsidiary of the Office of Thrift Supervision (OTS), which supervises the federally chartered thrifts. As a government–chartered stockholder–owned corporation, FHLMC buys mortgages and sells them in the secondary market.

Freddie Mac buys conventional loans from lenders such as savings banks, commercial banks, and mortgage companies. It then assembles a pool of mortgages and issues a security backed by the mortgages. The security is called a *Participating Certificate*, or *Guaranteed Mortgage Certificate*. The agency guarantees the full payment of principal and the timely payment of interest. The security is later sold to investors in the capital markets. For the guarantee, Freddie Mac receives a monthly fee paid by the investors.

CHARACTERISTICS OF FREDDIE MAC

- **Type of institution** – Federally sponsored secondary mortgage market agency.

- **Organization** – FHLMC is owned by the twelve Federal Home Loan Banks which are in turn owned by the savings and loan associations making up the system's membership. FHLMC has a three–member board of directors who are also the three members of the Federal Home loan Bank Board appointed by the President. FHLMC may borrow from the Treasury indirectly through the consolidated borrowings of the FHLB system. FHLMC is a profit–making enterprise which is tax exempt because it is owned by a non–profit government enterprise (the FHLB system) and distributes all its dividends to the system.

- **Functions** – FHLMC's purpose is to increase the availability of credit in the secondary mortgage market by:

    - Buying real estate loans and reselling them in mortgage pools.

    - Financing its loan purchases through the sale of stocks to the Federal Home loan Banks and through the sale of bonds and notes on the open market.

- **Mechanism** – In late 1982, FHLMC was given permission to issue preferred stock in addition to the non–voting common stock held by the banks. Aside from issuing newly authorized preferred stock, FHLMC raises funds for its operations by issuance of bonds and notes through the FHLB consolidated debentures system (limited); by sales of securities backed by pools of mortgages; and through imposition of commitment and servicing fees on users of the corporation.

- **Market Role** – Although FHLMC initially built up a portfolio of FHA/DVA mortgages, it now deals almost entirely in conventional mortgages, including standard, graduated, adjustable, and other forms. A federally mandated ceiling for home loans is adjusted annually in accordance with a price index. Loans within these ceiling limitations are termed "conforming" loans. FHLMC is a major source of multifamily rental project mortgage money. FHLMC packages substantially all of the mortgages it purchases into pools and issues securities (participation certificates, or PCs) against them. FHLMC also has issued certificates which perform more like bonds than "passthroughs" (guaranteed mortgage certificates, or GMCs). FHLMC is the major issuer of conventional mortgage–backed securities.

- **Authorization** – The FHLMC may buy and sell conventional, shared equity, FHA, and DVA loans, thereby encouraging the savings and loan associations to make more FHA and DVA loans.
- **Benefits** – Encourages growth in the secondary mortgage market by allowing the lenders to sell real estate loans (liquidity) and by providing the investors with these loans without the need for complicated loan origination or service Systems, thereby giving the borrowers greater choice of lenders.

☞***For more information on Freddie Mac please visit their web-site at www.freddiemac.com***

GOVERNMENT BACKED LOANS (FHA, DVA, CAL–VET)

There are two major categories of loans. One is ***government–backed loans,*** where Federal and state governments participate directly in residential loan financing, which include the Federal Housing Administration, the U.S. Department of Veterans Affairs, the California Department of Veterans Affairs, and ***non–government–backed loans***, which are a various city–backed subsidized home loan programs.

In this section, we discuss what these programs do and some of the advantages and disadvantages of these programs.

FEDERAL HOUSING ADMINISTRATION

The Federal Housing Administration (FHA) was created by the passage of the National Housing Act of 1934. With the passage of the Department of Housing and Urban Development Act, Public Law 89–174, all of the functions, powers, and duties of FHA were transferred to the control of the secretary of HUD. FHA was initially established as an experimental agency to help the national housing industry through the creation of a mutual fund for insuring mortgages made by private lenders. Many of the agencies that were created during the post Depression era have disappeared–but not the FHA. It has become a self–sustaining and standard setting agency for the federal government.

The purpose of FHA is threefold: (1) to upgrade the nation's housing standards; (2) to promote wider home ownership; and (3) to provide continuing and sound methods of financing home mortgages. But the majority of the financial community that was active in the financing of real estate looked upon FHA as governmental intrusion into the private financing of real estate, and it was not accepted as an answer to the housing problems.

The following are a number of important secondary results:

- Comprehensive system of valuing property and rating loan risk.
- Minimum standards of construction – referred to as Minimum Property Requirements(MPR).
- Scientific subdivision planning to help protect against neighborhood deterioration and confirm to environmental standards.
- Stimulation of mortgage investment on a nation wide basis.
- Long–term, lower interest rate loans.

The federal government was determined to make FHA a strong force in the financing of real estate. In 1938, the federal government set up an agency to sell bonds in the open market. The funds raised would be used to purchase mortgages insured by FHA from private lenders. The agency created for this purpose was the Federal National Mortgage Association (Fannie Mae). This made the federal insurance of mortgages even more attractive and was the birth of the secondary market as we know it today. The advent of Fannie Mae allowed lenders to sell mortgages that met the insurance requirements of FHA.

It must be remembered that FHA is not a lender. It does not make loans. FHA issues an insurance policy on loans that meet the underwriting requirements of the National Housing Act. This insurance policy ensures the lender that if the loan goes into default, FHA will make the loan good by taking the property and paying off the lender either in cash or with debentures guaranteed by the United States government.

FHA does appraise the property, and if the property is under construction, it can inspect the property throughout construction. In addition to the appraisal and approval of the property, FHA will approve the borrower. If the property and the borrower meet the underwriting requirements, FHA will insure the loan.

The insurance issued by FHA is called ***mutual mortgage insurance***, and FHA now charges either one–half of 1 percent per annum on the unpaid balance or a one–time lump sum, either paid as a lump sum at closing or financed as part of the loan. This charge is referred to as MIP, or the mortgage insurance premium. This insurance should not be confused with any other type of insurance, such as mortgage payment insurance carried on the borrower. The FHA insurance protects the lender from loss.

Since HUD–FHA was founded to serve all of the United States, the headquarters is in Washington, DC. The United States has been divided into ten regions and these regions have further been divided with the establishment of area offices to make FHA more responsive to the needs of the different areas of the country.

It should be noted, however, that in the recent past funding for these programs has been inhibited. Lack of authorization from Congress halted funding under this program for short periods during 1986.

California is part of Region IX headquartered in San Francisco. In addition to the San Francisco headquarters, there are HUD field offices located in Los Angeles, Fresno, Sacramento, San Diego and Santa Ana.

Major Loan Reforms

In addition to the introduction of mortgage insurance, FHA also introduced major loan reforms.

- **Higher Loan–to–Value ratios** – Prior to FHA, the loans on property were usually based on 50 to 60 percent of the sales price. FHA raised the loan–to–value ratio to 80 percent of value, a very high ratio for that time. Many lenders also had objections to the high loan–to–value ratio, saying that the investment was not covered by sufficient value even though the loan was insured for 100 percent.

- **Fully Amortized Mortgages** – Before the formation of FHA, most mortgages were like balloon mortgages, with all of the principal due at the term of the mortgage. In some cases, the mortgages were interest only with the interest payment due annually, and the full amount of principal due at the end of the term. The life of the mortgage prior to FHA was as little as three years, but FHA extended the term of the mortgages to as long as twenty years, with the payments due on a monthly basis. These payments were level payments. Each monthly payment was the same; only the amount applied to principal and interest changed.

- **Lower down payments** – The advent of the higher loan–to–value ratio meant a lower down payment to the homebuyer and thus made housing available to more of the general public.

- **Lower interest rates** – In keeping with the investment policy that the lower the risk the lower the return, the FHA loan usually has a lower interest rate than the conventional loan. The reason is that the lender is protected from loss by the FHA insurance.

- **Escrow accounts** – Prior to the FHA–insured loan, the person receiving the loan was responsible for seeing that all taxes were paid on time and that there was insurance on the property. As with most people, they did not make allowances for the once–a–year payments, and in many cases the property was lost due to a tax lien. Often the property was damaged by fire and the owner did not have insurance to cover the loss. FHA, with the advent of the escrow account, made sure that the lender was less likely to lose the property due to a tax lien and made sure that there was insurance coverage on the property. This was also an advantage for the property owner in that he or she did not have to make one lump sum payment for taxes and insurance, but would set aside one–twelfth of the cost each month.

- **Minimum property standards** – FHA was the first lender or insurer of mortgages to set minimum standards for the property. These standards have constantly been upgraded to make sure that the property securing the mortgage is safe, sanitary, and livable. The standards covered such things as the amount of insulation, the arrangement of rooms, the number of baths, and the type of wiring used in a house. Some have referred to these standards as a *national housing code.* The requirements of FHA were basically the same no matter where in the United States the property was located.

Then with the passage of the Housing and Urban–Rural Recovery Act of 1983 and the signing of the legislation on November 30, 1983, Title IV, Program Amendments and Extensions, Part A, Subpart 1, Section 405, entitled Minimum Property Standards all of the HUD–FHA minimum property standards for all types of properties other than manufactured housing were basically eliminated. Paragraph (2) of this section did keep in place the energy conservation portion of the minimum property standards. The paragraph states that the energy performance requirements developed and established by the Secretary of Housing and Urban Development under this subsection for newly constructed homes, other than manufactured homes, shall be effective as the energy performance requirements of the minimum property standards in effect as of September 30,1982.

The section further states that the Secretary of Housing and Urban Development may require that any property to be insured under any section of this Act, excluding manufactured housing, shall comply with one of the nationally recognized model building codes, or with any state or local code that is based on these model codes.

- **Standard borrower qualifications** – Lenders, prior to the advent of FHA, had no firm guidelines for the qualifying of the borrower, thus allowing the lender to set the rule for each person or applicant. They could have refused the applicant for any reason. Sometimes a loan was refused due to the type of work, marital status, race, or religion of the applicant.

MORTGAGE INSURANCE PREMIUM (MIP)

FHA mortgage insurance is a commitment to the lender that the loan will be repaid if the borrower cannot make the required monthly payments. The FHA secures funding for its loan insurance program by imposing a mortgage insurance premium that must be paid by each borrower obtaining an FHA–insured loan.

Historically, this income was sufficient to allow this agency to be one of the few self–supporting federal government programs, but FHA losses from foreclosures have risen dramatically, putting an unusual strain on its reserves.

As a result, the FHA has taken some drastic steps to reverse the foreclosure trend. The costs for securing an FHA–insured loan have been increased to discourage future defaults.

The up–front FHA mortgage insurance premium is 2.25 percent from 1995 and beyond. However, a new annual 0.5 percent premium has been added to the FHA monthly payments to be paid over specified periods of time that are determined by the LTV ratio, as follows:

	10% Down	10% – 5% Down	5% Down
1993–1994	7 years	12 years	30 years
1995	11 years	30 years	0.055 / 30 years

☞ ***Example:***

A $100,00 loan taken out in 1993 in a 5 percent down transaction would have the borrower pay $41.66 per month additional insurance premium to the FHA for thirty years

$100,000 x 0.005 = $500112 = $41.66

Although FHA managers maintain that their reserves, plus access to the U.S. Treasury, would be adequate to survive the current crisis, the new plan for higher costs should build up the reserve account and offset increased buyer defaults in the future. In an effort to limit its vulnerability, the FHA has discontinued insuring loans on vacation or second homes; or non–owner–occupied properties.

It is interesting to note that the FHA program was originally designed to help persons with low down payments qualify for loans with which to purchase homes and other real estate. By raising costs and down payment requirements, it may become comparatively less expensive to secure a conventional loan and the FHA program may see its original purpose disappear.

ADVANTAGES OF FHA

- **Low down payment** – With the higher LTV, the borrower is required to make a lower down payment. The down payment may be as little as 3 percent of the appraised value, but the usual down for the standard fixed-term, fixed–rate mortgage insured by FHA is 3 percent of the first $25,000 of appraised value, 5 percent of the next $100,000 and 10% on the amount over $125,000 to the maximum loan amount that will be insured by FHA in a specific area.

This method of calculating the required down payment applies to properties that have been constructed for one year or more or were constructed under FHA inspection. For those homes that are less than one year old or were not inspected during construction by FHA and/or VA, the required down payment is 10 percent of the value. Even though there is a difference in the down payment, the maximum loan amount is the same.

The usual down payment may vary with some of the programs available through FHA. As stated earlier, the easing of the down payments from approximately 50 percent allowed more people to purchase homes. Since the loans of FHA are relatively safe and possible loss to the lender is reduced, these loans usually have an interest rate that is below that charged on conventional mortgages or those loans with no governmental backing. With a lower interest rate, the monthly payments are lower, thus allowing a person to qualify for a greater loan amount with no increase in income. The effect that interest rates can have on the amount of the loan was dramatically illustrated in the high interest rates of late 1979 and into 1981. During this period, rates shot up from approximately 9.5 percent to over 18 percent. It was estimated that, with residential mortgage interest rates at 18 percent, only 5 percent of the population could afford housing.

- **Assumable** – FHA allows a person to assume an existing mortgage without the escalation or change of the interest rate. This escalation or change of interest for the assumption of a mortgage still exists today for some types of conventional mortgages. FHA felt that with America being a mobile society, the transfer of property should be made as easy as possible and one way was to allow those mortgages meeting the standards of FHA to be assumable On December 1, 1986, HUD made a major change in its assumption policy, in that any assumption made within 24 months after origination requires FHA qualification of the assumptor.

- **No Prepayment Penalty** – Probably one of the most important mortgage reforms instituted by FHA was to allow the borrower to pay off the mortgage prior to the due date of the mortgage without any prepayment penalty or prepayment premium. This lack of prepayment penalty is now a standard feature of all mortgages insured by FHA, but the penalty still can be found in many conventional mortgages. As a real estate professional, you need to know which conventional lenders in your area have prepayment penalties.

- **Minimum Property Standards** – As mentioned in the previous section, one of the reforms instituted by FHA was minimum property standards.

This is important to a purchaser of a new home in that they assure that the property has been inspected on a periodic basis and has been certified to conform to a minimum set of standards.

DISADVANTAGES OF FHA

Like all programs, the FHA loan has advantages as well as disadvantages. This section will discuss the major disadvantages.

- **Lengthy Process** – In the past, a disadvantage of an FHA loan was that the amount of time for FHA loan approval was rather long. In the past, HUD–FHA required that upon completion of the application and after all of the supporting data had been received, these materials must be sent to the nearest FHA underwriting office. After the materials were received, checked, and found to have no major errors, FHA would issue conditional commitment or conditional approval. This process was very time consuming and could take as long as 6 months in rare cases and usually took 6 weeks. Then on February 23, 1983, the Department of Housing and Urban Development implemented the Direct Endorsement Program. This gave to lenders that meet certain requirements the ability to give in–house approval on FHA–insured loans. Thus, the program cut the time required for loan approval. As a real estate professional, you should contact the FHA office serving your area and secure a list of the mortgage lenders in your area that have met the requirements of the HUD–FHA Direct Endorsement Program allowing them to give in–house approval of mortgages insured by FHA.

- **Upfront Discount Points** – The first disadvantage is that the seller, as with a conventional loan, in some cases may have to pay a discount or points to have a property financed through FHA. Up until 1983, FHA set the interest rate which was usually below the market rate for conventional mortgages. Sometimes the interest on FHA was too much below the conventional market and thus lenders were not interested in making FHA loans even though the risk was less. In order for the lender to be interested, he will require the seller to pay additional money up front. This money is usually expressed as a percentage of the ban, called points. Each point is equal to 1 percent of the loan amount. These points may be paid by the seller. These discount points ranged from 1 to as many as 8. Thus, if a person wished to sell a house and the FHA loan was $57,000, each point of discount that was charged by the lender cost the seller $570, or 1 percent of the loan amount.

- **Conforming to MPR** – The final major disadvantage to the FHA program is that if the property does not meet the minimum standards, prior to the final approval of the loan the property must be brought to the minimum. This cost can range from a few dollars to several thousand. The cost of repairs is usually borne by the seller, thus making this a disadvantage to the seller. In some instances, sellers will not sell their property FHA–insured because they know that it will not meet the minimum standards. From the purchaser's point of view, however, it is an advantage.

Characteristics of FHA Loans

- The maximum loan fee is 1% of the loan amount. The buyer normally pays this fee.
- Secondary financing is allowed with a new FHA loan provided the combined FHA loan and second loan do not exceed the FHA maximum.
- The maximum term is 30 years or 75% of the remaining economic life of the property, whichever is less. The amount of remaining economic life is determined by the appraiser.
- The FHA requires that monthly payments include principal and interest, taxes, fire insurance and Mutual Mortgage Insurance (MMI), often referred to as PIT + MMI. The monthly amounts paid toward taxes, insurance, and MMI are deposited in an impound account, also called an escrow account.
- There is no maximum purchase price. The buyer can pay more than the FHA appraisal. However, the loan will be based on the FHA appraisal if it is lower than the purchase price.
- The interest rates and discount points are completely negotiable between the lender and the borrower.
- The borrower must occupy the property.
- FHA appraisals (called "unconditional commitments") are good for six months on existing property and one year on new construction. The FHA uses independent fee appraisers who are "FHA qualified."

- The FHA requires that existing property must have no evidence of termite infestation. Certification must be obtained from a recognized termite inspection company.

- Borrowers must pay two mortgage insurance premiums. The first is identified by the initials MIP. It is an up–front fee measured by 1.5% of the loan amount in the case of a 30–year loan. It may be paid in cash through escrow, or it can be financed by adding it to the loan amount.

  The second, MMI, is paid monthly, measured by ½% (.5%) divided by 12, computed on the average annual loan balance, with this premium dropping slightly each year. For 15–year loans, the up–front fees are lower, and monthly MMI drops to .25%. If the borrower attends a qualified homeowner education class the up–front fees can be lowered further. MMI premiums may be dropped when the remaining loan balance is 80% LTV or less.

  Due to the complexity and constantly changing rules, it is suggested that you check with local lenders for the latest insurance premium charges at the time the loan is applied for.

- **Direct Endorsement** – A previous disadvantage was the length of time it took to approve an FHA loan. However, many lenders now have "direct endorsement" approval, which means the lender can underwrite the loans and do the FHA processing in–house.

  It should be noted, as explained below, that the FHA does place a dollar–limit on the maximum insured loan.

FHA Loan Amounts

Before writing up a purchase contract, a salesperson must know how the FHA calculates the maximum amount. Both FHA and conventional lenders base their loans on a fixed percentage of the lower of the property's sales price or appraised value. FHA multiplies this result by an appropriate percentage in order to determine the maximum loan amount it will insure. Maximums vary within states, and state–to–state, depending upon whether FHA has designated them as *"low closing cost"* or *"high closing cost"* states.

☞ ***California is classified as a "low closing cost" state.***

MAXIMUM FHA LOAN AMOUNTS

The percentages, based on the lower of sales price/appraised value are as follows:

Low Closing Costs States - $50,000 or less	98.75%
Over $50,000, up to $125,000	97.65%
Over $125,000, up to allowed maximum	97.15%
High Closing Costs States $50,000 or less	98.75%
Over $50,000, up to allowed maximum	97.75%

These limitations prevail as long as the borrower has a cash investment of at least 3% in the property. If the borrower has no investment in the property other than the down payment, the loan–to–value ratios will drop to an even 97%.

The 3% investment is ordinarily composed of down payment, plus the payment of enough qualifying ***nonrecurring closing costs*** to make up the difference. If the borrower invests more than 3%, the above–shown ratios apply. Discount points are not considered, nor are ***"prepaids,"*** such as taxes, insurance, and interest.

Allowable nonrecurring closing costs include such items as: loan origination fee, appraisal fee, credit report fee, title, and escrow fees.

In *calculating* the percentage of investment, only the lower of sales price/appraised value is considered. However, the allowable closing costs may be counted in the process of satisfying the 3% requirement. Calculations are set forth below.

☞ ***Example 1:***
Over $50,000, up to $125,000 (Low Closing Costs)

Sales price/value	$100,000
Maximum LTV ratio	X 97.65%
Maximum loan amount	$97,650
Sales price/value	$100,000
Maximum loan amount	–97,650
Down payment	$2,350

Minimum qualifying closing costs to be paid	$650
3% investment needed	$3,000

☞ ***Example 2:***
Over $125,000 (Low Closing Costs)

Sales price/value	$150,000
Maximum LTV ratio	X 97.15%
Maximum loan amount	$145,725
Sales price/value	$150,000
Maximum loan amount	–145,725
Down payment	$4,275
Minimum qualifying closing costs to be paid	$225
3% investment needed	$4,500

FHA regulations state that the required cash investment must be from the borrower's own funds, however, home ownership using FHA financing is made even easier: the funds–the 3% investment–may come from a bona fide gift, a loan from a governmental agency or instrumentality, or a loan from a family member. Any loan payments in addition to the primary loan must be counted in qualifying the borrower. The junior lien must not require a balloon payment within five years from date of execution.

The 3% investment may not come from loans from other sources, such as the seller, the builder, or premium pricing. If the seller or builder offers a $1,000 "decorating allowance" or similar inducements to purchase, the maximum loan basis is decreased by that amount.

FHA Titles & Sections

The National Housing Act of 1934 created the Federal Housing Administration. The act has eleven titles, or subdivisions, with further subdivisions called Sections.

Title I – Property Improvement Loans

FHA will also insure loans to finance improvements, alterations, and repairs of individual homes, apartment buildings, and nonresidential structures. Under Title I, loans on single family homes may be as high as $17,500 and the term of the loan may extend to 15 years and 32 days. Anyone eligible to meet the general FHA qualifying guidelines is able to secure a home improvement loan. For details once again, please visit their web site.

TITLE II – MORTGAGE INSURANCE LOANS

Title II of the National Housing Act sets up a permanent program of mortgage insurance loans made for the following purposes:

- Section 203 – To finance the construction or purchase of one–family to four–family dwellings, single–family dwellings for victims of a major disaster and low–cost single family homes in suburban and outlying areas.
- Section 207 – To finance the construction of large scale rental housing projects, seasonal homes, loans to certain veterans, and for mobile home parks.
- Section 213 – To finance the construction of nonprofit cooperatives of the management or sales type, and the purchase of individual mortgages released from a sales type project mortgage.
- Section 220 – To finance the rehabilitation of existing dwellings and the construction of new dwellings in designated urban renewal areas.
- Section 221 – To finance lowest new or rehabilitated housing for the relocation of families displaced by slum clearance projects or other governmental action. Section 221 is composed of three divisions: Section 221(d)(2) is utilized to finance single–family units, Section 221 (d)(3) to finance subsidized multifamily units and Section 221 (d)(4) to finance nonsubsidized multifamily units.
- Section 222 – To finance the purchase or construction of dwellings by servicemen on active duty with the Coast Guard and the National Oceanic and Atmospheric Administration.
- Section 223(f) – To finance the purchase or refinancing of existing multi–family projects. Minimum size – 8 living units.
- Section 231 – To finance the construction or rehabilitation of rental housing projects designed specifically for elderly persons.
- Section 232 – To finance the construction of facilities for skilled nursing care, convalescents and others who do not need hospital treatment.

- Section 233 – To finance single and multifamily units where the design and(or material used is of a nature to be considered experimental.
- Section 234 – To finance the purchase or construction of multifamily structures where the individual purchases the unit and is given deed to same along with undivided interest in common areas and facilities. This section is commonly known as the Condominium Housing Program.
- Section 235– To provide homeowner–ship assistance in the form of periodic payments by the FHA to mortgagees, which would reduce interest costs to the purchaser of market rate home mortgages and on the share of a cooperative association mortgage.
- Section 236 – To provide assistance to tenants and cooperators in the form of periodic interest reduction payments by FHA to the mortgagee for rental and cooperative housing projects serving low–income families.
- Section 237– To finance homeowner–ship for certain lower–income families who cannot qualify under normal standards because of their poor credit records, but who can meet mortgage payments with appropriate budget and financial counseling.
- Section 241 – To finance improvements or additions to a multifamily protect, nursing home, or group practice facility that is subject to a mortgage insured under a section or title of the Act.
- Section 242 – To finance new and rehabilitated (modernized) hospitals including major removable equipment to be used in operating them. The hospital must be owned and operated by one or more corporations or associations, eligibility of which is determined by the Public Health Service.
- Section 243– To provide homeowner–ship for middle–income families.
- Section 245 –To finance the purchase of a single–family dwelling under the Graduated Payment Mortgage Plan. Limited to owner–occupants, it permits lower monthly payments in the first 5 years of the loan, increasing each year to a final and constant level, higher than would be the case under 203b. Cash down payments usually are higher.

- Title X – To finance the purchase of new land and the development of improved building sites or to finance the development of new communities in amounts up to $25 million for any one project. Repayment periods may not exceed 10 years.

- Title XI – To finance a program providing group practice medical facilities for preventive, diagnostic and treatment services to ambulatory patients with mortgages up to $5 million with terms up to 25 years.

The most commonly encountered are Sections 203(b) and 245 described here.

Section 203(b)

Under the 203(b) program:

1. Anyone 18 and over is eligible.

2. Loans are available on properties of from one to four units.

3. U.S. citizenship is not required; resident aliens are eligible.

4. The FHA establishes a range of maximum loan amounts for one–to four–unit dwellings that vary according to area. For example, the California maximum loan on a single–family dwelling is $261,609. The cost of housing in a particular area determines the maximum loan amount, which is adjusted periodically to keep up with property values.

Figure 5-1: Freddie Mac Maximum Loan Amounts In High–Cost Areas (2002)

No. of Units	Loan Amount
1	$261,609
2	334,863
3	404,724
4	502,990

Section 245 – Graduated Payment Mortgage (GPM)

GPM is a mortgage where the early payments are low and rise over a period of time. It should be noted that the early payments of a GPM are not sufficient to cover the amount needed to amortize the loan fully, so the homeowner is borrowing additional monies that are added to the principal balance to be paid back in the future. To state this another way, it is said that the GPM for the first few years is in negative amortization.

Persons applying for the GPM must be aware that the monthly payments to principal and interest will increase each year for the next 5 years depending upon which of the GPM plans is selected. Applicants should also be aware that over the life of the mortgage, they will pay more interest than if they had secured a level–payment loan. Finally, any persons who will use the GPM must be made aware that they will have to make a larger down payment than those required under Section 203(b) or a level–term mortgage.

There are three GPM plans available to the prospective homebuyer. The three basic GPM plans vary the rate of the annual monthly payment increase from 2 percent per year to 7.5 percent per year.

The following will give the percent of increase and the number of years of increase for each plan:

> Plan I – The payment will increase at the rate of 2.5 percent per year for 5 years.
>
> Plan II – The payment will increase at the rate of 5 percent per year for 5 years.
>
> Plan III – The payment will increase at the rate of 7.5 percent per year for 5 years.

It is important to note that the monthly payments only increase yearly, not monthly, and that at the end of the fifth year the payments are level and are higher than those of a level or straight amortized mortgage. The reason for the higher payment, as stated previously, is that the homeowner has been in negative amortization and is now starting to repay the funds borrowed.

The GPM has the same term as mortgages insured under Section 203(b), that is, up to a maximum of 30 years.

The maximum loan amount under Section 245(a) is the same as 203(b). thus it is set area–by–area.

DEPARTMENT OF VETERANS AFFAIRS

The U.S. Veterans Bureau was founded in 1916 to assist needy veterans of the Civil War and Spanish American War. Its name changed to the Veterans Administration in 1930, then again in 1989, when it was elevated to cabinet level with the designation Department of Veterans Affairs.

The DVA is not usually a direct lender, but guarantees the lender against partial loss caused by default of a veteran borrower on a loan for a home (1 to 4 units), mobilehome with or without site, or a condominium or other cooperative unit.

PROCEDURE

These loans are administered by the U.S. Department of Veterans Affairs, formerly the Veterans Administration. A DVA appraiser estimates value and issues a **"Certificate of Reasonable Value"** (CRV). The loan is then made by an approved lender. (The DVA is permitted to make direct loans in some instances.)

ADMINISTRATION OF DVA

In 1944, Congress passed the GI Bill of Rights. This bill provided many benefits to veterans, including provisions guaranteeing real estate loans to veterans. The loan Guarantee Division of the Department of Veterans Affairs is responsible for administering the program. Generally, the DVA operates like the FHA. One difference is that the DVA guarantees a loan, and while the FHA insures a loan, and while the FHA insures the whole loan, the DVA guarantees a portion of it. As of 2002, the maximum guarantee on a loan is $60,000. The exact amount of guarantee to lenders in case of borrower default is based on the loan amount, as follows:

Loan Amount	Guarantee to lender
Under $45,000	50% of the loan
$45,000 to $56,250	$22,500
$56,251 to $144,000	40% of the loan
$144,001 to $203,000	25% of the loan
$203,001 to $240,000	$60,000

☞ ***Example:***

If a veteran were applying for a $180,000 loan, the guarantee would be $45,000 (25% X $180,000). If the loan were $40,000, the guarantee would be $20,000 (50% X $40,000).

Whether a loan is insured or guaranteed is important only if foreclosure occurs. In foreclosure cases, the DVA has two options:

1. It can pay the lender the balance on the loan and take back the property.

2. It can give the lender the property and pay it the amount of the deficiency, up to the maximum amount of the guarantee.

By contrast, under FHA loans, the lender is always paid off and the property is taken back by the FHA.

ELIGIBILITY / ENTITLEMENT

A veteran's eligibility or entitlement is derived from one of three active duty criteria:

- 90 days of continuous active duty; discharge because of a service connected disability; or separation under other than dishonorable conditions during any of the following wartime periods:

World War II	September 16, 1940 to July 25,1947
Korean Conflict	June 27, 1950 to January 31, 1955
Vietnam War	August 5, 1964 to May 7,1975
Persian Conflict	August 2, 1990 to present

- 181 days of continuous active duty for other than training purposes or discharge because of a service connected disability; or separation under other than dishonorable conditions during the following peacetime periods:

  July 26, 1947 to June 26,1950
  February 1,1955 to August 4,1964
  May 8, 1975 to August 8, 1980

- Two years of continuous active duty or separation under other than dishonorable conditions during the peacetime period from September 8, 1980 to the present.

Unremarried spouses of veterans may be eligible for DVA loans if the veteran died while in service of a service–connected injury or illness. Unremarried spouses of veterans who are listed as missing in action may also be eligible for OVA home loans.

As partners, several veterans, related or not, may purchase one–family to four–family homes as long as they intend to occupy the property. A veteran and a non-veteran may purchase a home together as co–borrowers, however the OVA will not guarantee the non-veteran's portion of the loan. The OVA does qualify common–law marriages without reduction of the loan guarantee for the non–veteran, as long as proper documentation has been recorded.

The two major advantages of the DVA loan are that no down payments are required on full entitlement loans and seller can pay all of the veteran's closing cost, including any escrow requirements. Thus, a veteran could purchase a home with absolutely no cash investment. Another advantage is that no mortgage insurance premium is required on a OVA loan, although there is a funding fee that can be paid in cash or added to the loan.

CERTIFICATE OF ELIGIBILITY

One of the most important documents needed for a loan application by a veteran is a ***Certificate of Eligibility.*** To receive this certificate, the veteran must secure forms for a Determination of Eligibility and Available Loan Guarantee Entitlement. These forms must be accompanied by evidence of military service. At present, veterans receive their certificate of eligibility with their discharge from service.

The Certificate of Eligibility indicates the amount of the veteran's entitlement. The ***entitlement*** is the maximum number of dollars that the DVA will pay if the lender suffers a loss. Since the maximum entitlement is $60,000, the maximum guarantee on a loan is therefore $60,000.

GENERAL INFORMATION ON DVA LOANS

The FHA has a number of loan programs. In contrast, the DVA has only one program, offering either fixed or adjustable interest rates, and one set of rules that generally applies to all its loans.

- **No Down Payment** – The DVA does not require a down payment – the veteran *is* allowed to borrow the full amount of the purchase price. What happens if the DVA appraises the property for less than the purchase price? At one time, the DVA would not allow the veteran to pay more than its appraisal. This caused real problems, since many veterans were willing and able to do so. This regulation prevented these veterans from purchasing a house of their choice. The regulation has since been eliminated. Now, the DVA will allow a veteran to pay more than the appraisal, but the loan amount cannot exceed the appraisal. The difference between the purchase price and the appraisal has to be in cash, and the money cannot be borrowed.

- **Type of Property** – The DVA guarantees loans on properties from one to four units and units in planned unit developments and condominiums. The DVA approves new properties only if they were built under FHA or DVA inspections. If a property was not built with FHA or DVA inspections, you have to wait one year after the house has been completed. Then you can order the appraisal. Some exceptions to this one–year rule are (a) property located in a remote area where obtaining FHA or DVA inspections would be inconvenient; (b) property built by a small builder who does not normally use DVA loans to finance the sale of houses.

- **Owner Occupying the property** – The veteran must occupy the property. The DVA does not have a program for veterans who do not intend to occupy the property.

- **Monthly Installments** – Technically, the DVA requires only monthly principal and interest payments. It does not require property taxes and insurance to be included. However, the DVA recommends that these be included, and the deed of trust provides lender authority to collect them. As a practical matter, all DVA loans include the taxes and insurance in the monthly payment.

- **Interest** – Must remain at original loan rate except on adjustable rate mortgages (ARMs).

- **Repayments** – May be with equal monthly payments of principal and interest or on a graduated payment plan.

- **Prepayment Penalty** – None

- **Secondary Financing** – Allowed if certain conditions are met; subject to DVA review.

- **Discount Points** – Seller must pay discount points, except on construction loans or refinancing.

- **Taxes and Insurance** – Impounded and prorated in an amount included in the monthly payment.

- Assumption and Resale –

- **Assumption** – Another Veteran. One veteran may assume another veteran's loan by substituting eligibility.

  - **Non–Veteran** – The GI loan may be assumed by a non–veteran with USDVA approval, although USDVA approval is not required for loans made before March 1, 1988. Unless the veteran (seller) obtains a "release from liability" certificate from the DVA, the veteran remains liable. Even with USDVA approval of assumption, the veteran does not regain eligibility until the loan is fully paid off.

  - The veteran may sell to another eligible vet who agrees to assume the loan; however, unless the new vet obligates his entitlement to the assumption, the original vet remains liable unless given a release of liability from the DVA.

  - "Subject to"–The veteran remains primarily liable.

- **Interest rate** – The interest rate and discount points are negotiable between lender and veteran–borrower. The seller may pay the discount points, the buyer and seller may split the payment, or these points can be paid by a third party.

- **Loan origination fee** – The lender may charge the veteran borrower up to one point loan fee, which goes to the lender, plus a funding fee (points), which goes to the Department of Veterans Affairs and is based upon the amount of down payment:

  - 2% for loans with less than 5% down.

  - 1.5% for loans from 5% to less than 10% down.

  - 1.25% for loans with 10% or more down, and for all loan assumptions.

  - 1% for loans on manufactured homes.

Higher fees apply to Reserve and National Guard members.

- **Loan Term** – The term cannot exceed the remaining economic life of the property, with a ***maximum term of 30 years***.

- **Maximum Loan** – There is no maximum loan amount under DVA rules. This does not mean you can obtain a no–down DVA loan in any amount. Since the DVA guarantees only a portion of the loan, lenders limit the amount they will lend on DVA loans. Most lenders use the maximum loan amount set in the secondary market.

  As stated earlier, since the bulk of DVA loans are sold to Fannie Mae or Freddie Mac, lenders follow FNMA or FHLMC rules. Both agencies limit the maximum loan to four times the entitlement. At the present entitlement of $60,000, the maximum loan would be $240,000. when the entitlement is increased, the maximum loan is thereby increased. The main point to remember is that the DVA does not set the maximum loan amount; it is the lender that determines the amount. Regardless of the loan amount, the DVA will not reimburse the lender for more than the amount of entitlement, regardless of what the lender's loss may be upon foreclosure.

- **Gifts** – Gift letters are required to confirm the nature of gifts.

- **Additional Income** – Child support and alimony can be acceptable income for qualifying if received monthly and consistently.

- **Co–Buyers** – If both husband and wife are veterans, the amount of the USDVA guarantee may be doubled. Also, several veterans may use their entitlements to acquire property together.

- **GPM – Graduated Payment Mortgage**. – Since 1981, the DVA (now the USDVA) has been authorized to guarantee GPM loans, which require small down-payments but allow lower monthly payments for the first year, increasing annually during a graduation period. There is negative amortization during this graduation period. The plan is based on Plan III, Section 245, FHA–insured loans. This plan provides for increasing loan payments at a rate of 7 ½% per year for the first five years.

- **Refinance – Interest Rate Reduction**. An existing GI loan can be refinanced with a new USDVA–guaranteed loan at a lower interest rate without the use of additional loan guarantee entitlement. The refinancing loan must be secured by the same home. The loan may not exceed the old loan balance plus allowable closing costs and a reasonable discount. The veteran may not receive any cash proceeds.

- **Requirements** – USDVA–to–USDVA refinancing is a much simpler process than obtaining a new GI loan:
  - No termite inspection is required.
  - No credit report is required; however,
  - Rear payments must have been made on time.
  - The loan fee can be included in the new loan.
  - The appraisal must establish an adequate value to secure the new loan balance.

- **Appraisal** – The DVA–completed appraisal is turned in to the Regional Office to be checked and reviewed. The next step is to issue a Certificate of Reasonable Value (CRV). Reasonable value means current market value, which the certificate states. In practice, the DVA never issues a certificate showing a value greater than the sales price. If a property sells for $140,000 and the DVA believes the property is worth $145,000, the CRV will show a value of $140,000. However, if it believes the property is worth only $136,000, the CRV will show a value of $136,000. CRVs are valid for six months.

- **Secondary financing** – It is commonly believed that a second loan on a DVA transaction is prohibited. This is not technically correct. Seconds are allowed but rarely used because they are not practical or not understood.

  Secondary financing can be approved on a case–by–case basis. The DVA Regional Office will determine on what basis it is acceptable. Generally, it is desirable that the second carry the same interest rate and terms as the first loan. The first and second loans added together cannot under any circumstances be more than the CRV. An example where a second can be used is as follows:

Sales price/CRV	$266,000
Maximum loan available from lender	–240,000
Down payment from buyer	– 20,000
Second mortgage	$ 6,000

In this example, we need an additional $6,000 to complete the transaction. If the seller is willing to carry back a second loan at the same rate and terms as the first, the sale can be made.

- **Termite reports** – The DVA requires that a structural pest report be obtained from a recognized inspection company. Necessary work must be done, and both the veteran and an inspector must certify that the work is done satisfactorily.

- **Closing costs** – The DVA has several rules that are unusual. The DVA will not allow the veteran to pay for nonrecurring closing costs, such as termite reports, escrow fees, tax service fees, document preparation fees, notary fees, or a certificate of reasonable value that was ordered before the veteran agreed to purchase the property.

  The DVA allows the seller to pay all of the closing costs, including prepaid expenses and recurring closing costs such as tax impounds, fire insurance, and so on. Most lenders require buyers to pay for prepaid items. A ***"seller pay all"*** is often referred to as a **"**DVA no–no**"**–no down, no closing costs.

In the discussion of FHA loans, the advantages and disadvantages were listed. Most of the advantages and disadvantages also apply to DVA loans. Some differences, however, are worth listing.

ADVANTAGES OF DVA LOANS

In comparison with conventional loans, USDVA–guaranteed loans have these advantages:

- **No Down Payment** – DVA–guaranteed lenders ordinarily do not require any down payment on loans up to $240,000. This is the maximum that FHLMC and FNMA will purchase in the secondary market, to be discussed in Chapter 7. Since $60,000 (.25 x $240,000) is the maximum guarantee to lenders, the difference, $180,000, is the lender's exposure, or risk (75% loan–to–value). The relatively high loan amount without a down payment requirement makes a DVA loan highly desirable. The **"**no down**"** feature is ideal not just for moderate–income people. Business and professional people are also attracted to DVA loans because they can use the money they save on a DVA loan in their business or other investments.

- **No Closing Costs**, or minimal closing costs.

- **Easy Qualifying** – DVA loans has a better qualifying ratios than the conventional loans. Qualifying DVA loans will be discussed in details in chapter 13.

- **No Prepayment Penalty** – The veteran–borrower may pay off the loan in full at any time without penalty.

- **Assumable Loans, with Limitations** – Loans made before March 1, 1988, are freely assumable. Properties can even be sold subject to that existing financing, although no release of liability could be obtained with such a sale. For loans made and guaranteed by the USDVA since March 1, 1988, the USDVA or the loan holder must give prior approval for any sale of property securing USDVA loans unless the loan is paid in full. When approved the loan is assumable on its original terms.

- Lower–than–market interest rates.

- **Appraisal** – DVA appraisals, known as ***Certificates of Reasonable Value*** (CRVs), are made by independent professional appraisers who work for the DVA on a fee basis. Appraisals are made to protect the veteran buyer. The DVA informs the buyer what it thinks is a reasonable value for the property. The buyer is allowed to pay more than that value if he or she agrees. This is protection for a buyer who is not aware of property values. However, the buyer can back out only if the appraisal is ordered after the purchase contract is executed.

Disadvantages of DVA Loans

DVA loans have basically the same disadvantages as FHA loans.

- **Qualifying** – Certificate of Eligibility. The veteran must have (or obtain) a Certificate of Eligibility from the USDVA. This establishes the amount of the guarantee entitlement, whether full or partial.

- **Discount Points** – Lenders are not permitted to charge discount points to "GI loan" borrowers of purchase money loans. Therefore, a seller is required to pay the discount points for a buyer financing the purchase with a GI loan. Some sellers are reluctant to pay the necessary discount points, especially in an active market with many qualified buyers.

- **Employment** – Two years employment in the same field, or employment in the field of a college degree or specialized training. Special consideration may be given to a veteran recently discharged with very little civilian employment experience.

- **Bankruptcy** – Consideration is given case by case for veterans who have experienced bankruptcy and since reestablished a credit record.

- **Debts** – Payment obligations that will continue for six months or more will be considered. Five percent of credit card balances will be considered monthly payment obligations.

- **Lengthy Processing Time** – Except for loans made by "supervised lenders" (banks, S&Ls, and life insurance companies) which can make automatically guaranteed loans, you run into the same problem with the DVA and the FHA. Processing time, inflexibility, paperwork, and the usual problems in dealing with a large government agency are disadvantages unless the lender is qualified to process DVA automatics, which are in–house approval programs.

- **Property Standards** – The property must meet strict clearance requirements, such as pest control inspection and code requirements.

  The DVA also requires repairs that it feels are necessary. In some cases, the DVA requires a certification from the city or county that the property meets current building codes.

- **Lender Limits** – DVA loans are usually not more than four times the guarantee, or $240,000 without a down payment. DVA itself does not prescribe a maximum, but lenders want saleable loans, hence their policy of limiting veteran loans to four times the $60,000 DVA guarantee, according to FNMA/FHLMC "market" requirements.

CAL–VET LOANS

The Cal–Vet program is administered by the California Department of Veterans Affairs, Division of Farms and Home Purchases.

Under the California Veterans Farm and Home Purchase Act, the state sells bonds to raise funds to help veterans purchase a **"**farm or home,**"** including mobile home, townhouse, or condominium (but not income properties, multiple units, or prefab or modular homes).

Applicants may appoint their own real estate agent to act on their behalf, or apply through a Cal–Vet certified mortgage broker and pay a one–point loan origination fee (which can go to the mortgage broker). The money that funds the loans is obtained from the sale of general obligation bonds and revenue bonds. There is also a program using what are designated as ***"****unrestricted funds****"*** for qualified veterans with wartime service. This can be used only as funds are available.

ADMINISTRATION

The program is administered by the California Department of Veterans Affairs.

- DVA appraises properties (may accept FHA or DVA appraisal).
- DVA prepares most of the documents needed in escrow, resulting in minimal closing costs. A small loan origination fee is charged.
- DVA services the loan until paid in full.
- Expiration – California veterans must apply for a Cal–Vet loan within 25 years following release from active duty, except that those who were wounded or are disabled or were prisoners of war have 30 years.

CHARACTERISTICS OF CAL–VET LOANS

- **Eligibility** – Cal–Vet financing is available to California veterans who served honorably during wartime in the armed forces of the United States. The veteran must be a native Californian or a bona fide resident at the time of entry into the service, and must have participated in a military expedition or campaign for which a medal was authorized by the government.

- **Minors** – Minors who lived in California for 6 months immediately preceding entry into service from California are eligible.

- **Spouses** – Eligibility extends to unremarried spouses of California veterans who were killed in action, are prisoners of war, or are missing in action.

- **Property** – Cal–Vet has generally the same property standards as FHA and DVA. The property must be a single–family dwelling or a unit in a planned unit development or a condominium. Cal–Vet requires a structural report and generally a roof inspection.

- **Maximum purchase price** – None

- **Maximum Loan** – The maximum home loan is $250,000, Farm loans may go as high as $300,000, and mobile homes up to $70,000. An additional $5000 can be borrowed to install solar heating devices.

- **Down Payment** – Cal–Vet has DVA–guaranteed backing, and may use PMI as well in certain cases. On loan amounts up to $240,000, the loans are DVA guaranteed. The down payment requirement is 2%.

  On loan amounts over $240,000, not to exceed $250,000, the down payment requirement is 3%. In this case, the CDVA uses private mortgage insurance, with a funding fee equal to the DVA funding fees. These fees range from 1.25% to 3% if the down payment is 2% (with a maximum of $240,000 total), and from 1.25% to 2% if the down payment is 3% (over $240,000 up to $250,000). These one–time loan guarantee fees enter the picture when the down payments are less than 20%, and can be paid by seller or buyer. On loans up to a maximum not exceeding $240,000, the fee can be financed. If the loan amount exceeds $240,000, the fee must be paid up front in cash.

- **Prepayment Penalty** – Now the same as on other owner–occupied homes: 6 months' interest 9n the amount prepaid in excess of 20% of the original loan amount, if pre p aid during the first 5 years.

- **Impound** – Required for taxes and insurance. Included in monthly mortgage payments are principal, interest, property taxes, and fire, disability, and life insurance premiums.

- **Term of Loan Repayment** – Usually 30 years but can later extend for up to 40 years under extenuating circumstance.

- **Interest Rate** – The interest rate is variable. The rate is checked periodically to determine if a change is necessary (it has never exceeded 8%). When the interest rate changes, either the monthly payment or the amortization period may be changed. The cost of the bonds and running the program determine the interest rate. Start rates may vary with market considerations. In 2002, revenue bond programs were 6% with a cap of .5% over the start rate; general obligation bond programs were at 7.25% (for mobile homes, add 1 percent); and unrestricted funds were at 6.5%.

  The department also has a lower interest rate for the qualified mortgage bond program, using revenue bonds only, for "first time home buyers" and for "targeted area purchasers." There are purchase price limitations and income limits for target and non–target areas. These are set according to guidelines furnished by the federal government, and Cal–Vet has no discretion regarding these limitations.

- **Secondary Financing** – At the time of purchase, secondary financing is permitted. The combined Cal–Vet loan and secondary financing cannot exceed 98% of the Cal–Vet appraised value.

- **Title to Property** – When a property is being financed with a Cal Vet loan, title is first conveyed to the Department of Veterans Affairs of the State of California by the seller. The department then sells the property to the veteran under a *land contract of sale*. The department continues to hold legal title until the veteran has paid the loan in full, after which the buyer gets a grant deed. The department uses a standard CLTA joint protection policy, rather than a "lender's" ALTA policy.

- **Loan Origination Fee** – The application fee is $50, plus an appraisal fee paid by the applicant.

- **Refinancing** – No refinancing are available, with a possible exception where a Cal–Vet take–out is arranged prior to obtaining an "outside" construction loan, and prior to transfer of title to property. However, if your old loan is paid off, a new Cal–Vet loan is available. Cal–Vet loans may be paid off without penalty and may be used over and over.

- **Occupancy** – The veteran or an immediate member of the family who qualifies as a dependent must occupy the property.

- **Death** – A Cal–Vet must apply to be insured under the State's Home Protection Plan of life Insurance. If approved for life insurance, the basic coverage provides for payment in full of the contract balance as of the date of death of the insured.

- **Disability** – Disability insurance is required for those under age 62 whose health condition is acceptable and who are working full time for full pay. The disability insurance terminates at age 62 unless benefits are being paid at that time.

- **Fire and Hazard Insurance** – DVA contracts for fire and hazard insurance for most properties. Premium payments for this and other insurance are included as a part of the loan installment.

- **Construction Loan** – All other qualifications remain the same. Cal–Vet usually uses a five–draw system, with the construction period ordinarily nine months, followed by 29–year/3–month amortization.

ADVANTAGES AND DISADVANTAGES OF CAL–VET LOANS

The main advantages of the Cal–Vet loan are its relatively low interest rate; inexpensive life, fire, and disaster (flood, quake) insurance; and low closing costs.

Disadvantages include lack of refinancings and occasional shortage of available funds for the program. For unmarried couples, another disadvantage might be that Cal–Vet can refuse to allow assignment of the veteran's contract of sale to the couple as joint tenants.

Table below compares the different types of government–backed loans.

Figure 5-1: Comparison of Government–Backed Loans (as of January 2002).

FEATURE	FHA	DVA	CAL–VET
Purpose of loan	1–4 units	1–4 units	Single dwellings, condominiums
Eligibility	U.S. resident	U.S. veteran	Qualified veteran
Expiration of eligibility	Indefinite	Indefinite	Must apply within 30 years from date of

			discharge
Maximum purchase price	None	None	None
Maximum loan	Varies by counties 261,609 334,863 404,724 502,990	None by DVA; lenders limit loan amount	$250,000 for homes $300,000 for farms
Down payment	Minimum 3%	None, but limited to CRV	2% to 3%
Maximum term	30 years	30 years	30 years
Secondary financing	Allowed with limitations	Allowed with limitations	Allowed with limitations
Interest rate	Fixed	Fixed	Variable rate
Prepayment penalty	None	None	None

☞ ***For more information on Cal–Vets, please visit their web-site www.cdva.ca.gov***

STATE AND LOCAL REGULATIONS

In addition to direct government involvement in real estate finance, mostly at the federal level, there are state and local agencies and programs that have important direct and indirect influence.

STATE FINANCIAL AGENCIES

These enforce and are regulated by the laws pertaining to California licensed savings and loan associations, banks, insurance companies, credit unions, and mortgage companies. These agencies can have far–reaching effects upon the mortgage market.

- Department of Savings and Loan
- Department of Banking
- Department of Insurance
- Department of Corporations

- Department of Real Estate
- California Housing and Financing Agency

LOCAL GOVERNMENT AGENCIES

Many local agencies and commissions can affect the mortgage market in terms of demand and Supply of money and property in their immediate area. Some of these are:

ZONING COMMISSION

- Tax assessor's office
- County supervisors and city council Building and safety departments
- Fire, police, park, utility, and transportation departments

CALIFORNIA HOMESTEAD LAW

California law permits homeowners to protect their residences from forced sale to satisfy certain types of debts, by recording a Declaration of Homestead.

PROTECTION

The protection offered by homesteading is limited as to type of property, types of debts, and amount of exemption.

- **Eligible Property** – Any residence may be homesteaded, but vacant land is not eligible.
  - Single–family residence, including a mobilehome
  - Multiple units, if one unit is owner–occupied
  - Unit in condominium, community apartment, or stock co–op
  - Business–residential property if primarily residential

- Dwelling on land that is leased with an unexpired term of two years or more

- **Claims Protected Against** – Homesteaded property is protected against judgments recorded *after* the recording of a declaration of homestead, for:
  - Damages
  - Medical bills
  - Business debts

- **Claims Not Affected** – Homesteading does *not* protect against *secured* liens of taxes, mortgage, trust deed, or mechanics liens, nor against an unsecured lien recorded prior to the recording of the homestead declaration.

- **Amount of Protection** – The home is protected against seizure and sale as long as the owner's equity does not exceed the allowed exemption of:
  - $30,000 for any person, except
  - $45,000 for a member of a **"**family unit**"**
  - $75,000 if the homestead declarant or the declarant's spouse is 65 years of age or older, or physically or mentally disabled and thus unable to work, and this is so stated in the declaration, or if the declarant is 55 years of age or older with a gross annual income of not more than $15,000 ($20,000 per year for a married couple).

The proceeds from a forced or voluntary sale of a homestead must be reinvested in another home within 6 months, or proceeds are available to claims remaining after sale.

Claiming the Exemption

The declarant must record the homestead in the county where the property is located.

- **Effects** – A recorded declaration of homestead:
  - Will be valid against eligible debts if recorded any time prior to the recording of the unsecured creditor's judgment.

- May be declared by either spouse on community, joint tenancy, or tenancy in common property, but not on separate property of the other spouse in which declarant has no ownership interest.

- Is not an encumbrance.

◆ **Required Information** – Declarant must state the following. Any false statement invalidates a homestead.

- Claimant is "head of family," if such is the fact

- If married, name of spouse

- Whether 65 years of age (to obtain higher exemption amount)

- Resides on premises claimed as a homestead

- Description of premises

◆ **Termination** – A homestead is ended by three methods only:

- Recording notice of "Abandonment of Homestead"

- Sale of homestead property

- Recording of a subsequent "Declaration of Homestead."

FORCED SALE OF A HOMESTEAD

If the owner's equity exceeds the exemption, a court may order the property sold to pay the claims of judgment creditors.

◆ **Priority of Distribution** – Money realized from the forced sale is allocated to outstanding claims in the following order.

1. Cost of sale

2. Taxes and assessments

3. Secured liens (mortgage, trust deed, mechanics liens, etc.)

4. Declarant's exemption

5. Unsecured creditors claim

6. Balance to declarant (if any)

- **Decision to Sell** – The court's decision to order a sale is based on whether the proceeds will satisfy the debts. If the total of the first four priorities is less than market value, the property is sold.

Decision to Homestead

There is no need for a declaration of homestead until a suit has been filed which threatens financial disaster.

- **Timing** – Homestead can be recorded up to judgment date. There is no need to record until trial date, if any.

- **Effect on Credit** – Prospective creditors may be suspicious of a loan applicant if homestead has been recorded on the property being used as collateral. (**"**What other creditor is this owner trying to avoid?**"**)

- **Last Minute Protection** – California Civil Code Sections 1240 and 1245 and Code of Civil Procedures Sections 690 et seq. provide limited protection for a non–homesteaded home. When a writ of execution is served, the homeowner has 10 days to record a special claim of exemption, subject to court hearing.

- **Licensee's Role** – A licensee who is not an attorney should never advise on a homestead issue. It would be practice of law without a license, and the licensee could be held liable for any financial damage caused. A licensee is obligated to inform those he serves, and should suggest they obtain proper legal advice in manners such as these.

☞ Internet Web Links

www.fanniemae.com	Supplier of conventional home mortgages funds in terms of assets, and issues debt.

www.freddiemac.com	Stockholder–owned corporation chartered by Congress in 1970 to create a continuous flow of funds to mortgage lenders.
www.ginnemae.gov	About Ginnie Mae. What's New. ARMs. Guides. Resources....What's New. Ginnie Mae Training For GinnieNET. ...
www.ofheo.gov	Office Of Federal Housing Enterprise Oversight (OFHEO). OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).
www.va.gov	Provides information on VA programs, veterans benefits, VA facilities worldwide, and VA medical automation software.
www.hud.gov	U.S. Department of Housing and Urban Development (HUD)
www.fhatoday.com	FHA mortgage center offers purchase and refinance loans to home buyers nationwide. FHA mortgage lender offers purchase and streamline refinance mortgages to home buyers nationwide.
www.cdva.ca.gov	Cal–Vet Loans, Now is a Great Time to use a Cal–Vet Loan! If you're ready to buy a home, Cal–Vet is here to meet your home financing needs!

CHAPTER QUIZ

1. The FHA title that is used to purchase homes is:

   A. Title I
   B. Title II
   C. Title III
   D. Title IV

2. FHA–insured loans insure lenders against

   A. Decline in real estate values.
   B. Loss due to foreclosure.
   C. Loss due to borrowers losing their jobs.
   D. Late payments by borrowers.

3. Among the secondary objectives and results accomplished by the FHA are:

   A. Comprehensive system of valuing property and land mortgage risks
   B. Minimum standards of construction
   C. Scientific subdivision planning to protect against neighborhood deterioration
   D. All of the above

4. The FHA has established certain MPRs that must exist before they will insure a loan. MPR is an abbreviation for:

   A. Maximum probability ratio
   B. Mortgage protection rate
   C. Minimum property requirements
   D. Market price rating

5. A program where GNMA and FNMA for buying loans at par, which is less than market value, is known as:

   A. A pass through
   B. The Tandem plan
   C. REMIC
   D. Discounting

6. When the Federal Reserve Bank feels that there is an inflationary trend in the United States, it is likely to do which of the following:

A. Adjust the amount of reserves required for its member banks
B. Increase the discount rate
C. Enter into the government bond market in a selling capacity
D. All of the above

7. The term ***CRV*** refer to:

A. Certified regional valuations.
B. Certified Reasonable value.
C. A loan guaranteed by the Department of Veterans Affairs.
D. A real estate agent who specializes in GI loans.

8. The Federal Home Loan Bank:

A. Insures savings and loan associations against losses
B. Acts as a "banker's bank"
C. Insures commercial bank depositors against loss
D. All of the above

9. The Federal National Mortgage Association:

A. Is a stockholder–owned corporation
B. Purchases FHA, DVA and conventional loans
C. Is the leading secondary money market for mortgage notes
D. All of the above

10. The following is used as the security instrument to finance a Cal–Vet loan:

A. Deferred deed
B. Land contract
C. Mortgage
D. Trust deed

Answer Key: 1–B, 2–B, 3–D, 4–C, 5–B, 6–D, 7–B, 8–A, 9–D, 10–B

CHAPTER 6: HARD MONEY LOANS & CONVENTIONAL LOANS

PREVIEW

This chapter covers conventional loans, their advantages and disadvantages, and how to compare one lender with another. Buy–down loans are explained, and several examples are given. The California Fair lending Regulations are outlined and analyzed. The chapter concludes with a discussion of private mortgage insurance companies. We will then look into the two types of loan, the *conventional* and *nonconventional* which was discussed in previous chapter.

SOFT MONEY LOANS

A **soft money loan** is a loan where credit is extended but cash does not change hands, such as a purchase money loan where the seller finances the buyer. The buyer would give the seller a trust deed secured by the property purchased for the seller's equity rather than pay cash by using savings or a loan from a third party lender.

HARD MONEY LOANS

Hard money refers to cash. In a hard money loan cash actually changes hands, although generally in the form of checks.

☞***The term "hard money loan" has come to mean more than just a cash loan. It is a loan made by an individual rather than institutional lender.***

Hard Money Maker

A ***hard money maker*** would be a lender who uses lender funds to make the loan. While the funds used may be borrowed, the lender is at risk (we do not generally regard institutional lenders as hard money makers. We consider private lenders to be hard money makers).

Hard Money Arranger

A ***hard money arranger*** is neither the borrower nor the lender. The arranger is the person who brings the parties together such, as a real estate loan broker. The arranger finds a person willing to put up cash secured by a lien on real property and a person willing to place a lien on real property in exchange for cash.

When we speak of hard money arrangers, we are normally speaking of arrangers between private investors, rather than institutional investors and borrowers.

Sources of Funds

Private Individuals

Most loan funds are from personal or business savings. Some loan arrangers have sought investors owning homes who had very low debt–to–equity ratios as well as those having debt free residences. By refinancing, they are often able to borrow at a much lower interest rate than they can loan their money at. They are thus able to make money on this interest differential by trading on their equity. Even if their loans are well secured, the investor in such a situation is placed at risk. Should the lien that they hold go into default, they may not have the funds to make their own mortgage payments, which would place their home at risk of foreclosure.

Pension Funds

Pension funds are not taxed on earnings so theoretically they should be able to make investments with lesser yields. In practice, pension funds are being pushed to perform well.

Pension funds have discovered real property secured loans as an acceptable balance between risk and yield. Both private individuals and private pension funds can avoid the usury limitations and receive higher rates of interest by using brokers as arrangers of their loans. (If they made the loans direct, the usury law would apply.) Public pension plans are exempt from usury limitations as are other licensed lenders.

Disclosure statements as to the particulars of a loan being offered that is secured by real estate is required.

Disclosures need not be given to trustees of pension, profit sharing or welfare funds having assets of $15 million or more. Pension funds with less than $15 million in assets are treated as other non–institutional lenders. These pension funds receive the Protection of required disclosures.

Persons who are borrowers on these hard money loans are generally willing to pay interest charges greater than they would have to pay from institutional lenders because, for a variety of reasons, they are unable to obtain financing from banks or savings bank institutions.

Loan Characteristics

Income

Income indicates a borrower's capacity to make loan payments. The income figures should be obtained from the borrower and verified where possible. Verification might be from the borrower's pay check stubs or even copies of prior income tax returns. Information of the income and what verification was made must be given to the lender.

☞ ***Reported income on tax returns for owners of small businesses may be less significant to a lender than would wage income.***

In cases of under reporting of income to defraud the government, small business owners frequently jeopardize their position when conventional lenders will not grant them purchase or equity loans because the small business owners lack the capacity (on paper) to repay the loan.

Asset Based

Loans are secured by real property.

☞ ***The value of the real property*** $_{T}$ ***is the paramount criteria for making the loan.***

The lender, while generally preferring performance from the borrower, wants to know that in a worse case scenario (foreclosure) he or she is protected. The following factors are of far lesser importance.

POOR CREDIT

A history which indicates problems in the past will deter most conventional lenders. Since hard money makers are primarily interested in the security, many will make loans in cases where the borrower appears risky and even likely to default if the property value warrants the loan. Some hard money lenders are also dealers in real property. These lenders will make loans in situations where they would be delighted if the borrower defaulted and they ended up owning the property.

CREDIT DISCLOSURE

Even though a loan may be based on asset value, the arranger of hard money loans has a duty to protect and fully inform lenders and borrowers. Credit of a borrower must be checked out. Assuming that a borrower has financial strength based on his or her possessions and lifestyle could result in loan broker liability. The normal procedure is to obtain a TRW–type credit report from a credit reporting agency. If the report is insufficient, such as no reported credit history, the loan arranger should request an investigative report.

☞ ***The credit information must be disclosed to the lender.***

PURCHASE MONEY LOANS

Purchase money loans are loans to purchase real property. It is an equity based purchase loan.

☞ ***Most purchase money loans are made by institutional lenders who offer significantly lower loan costs and interest rates.***

Some of the reasons hard money arrangers get involved in purchase money loans include:

- **Property Type** – Most institutional lenders are not interested in loans on raw land or lots. It is often difficult to obtain loans on special purpose buildings or properties which are considered distressed for a variety of reasons.

- **Capacity** – Due to outstanding debt or low income, a person might not meet the proper ratio requirements of income to debt service costs. In reality, people can often afford what they want. In Orange County, many people pay over 50% of their income to be able to live in a desirable area.

  Ratios are more likely to be used as a guide by hard money lenders rather than as a rule that has been cast in stone.

- **Credit** – Prior credit problems because of personal problems or just neglect disqualify many buyers from conventional loans. Hard money lenders are less likely to be concerned with minor credit problems and sometimes they are not terribly concerned with major problems.

EQUITY BASED LOANS

Equity loans are loans that cover a property owner's equity. Equity is the difference between all of the liens and obligations against a property and the fair market value of the property.

☞ ***The majority of hard money loans are equity–based loans.***

For reasons covered under purchase loans, borrowers frequently cannot obtain equity loans from conventional lending institutions. In addition, appraisals by lending institutions have changed. At one time, appraisals were very much on the optimistic side when lenders wanted to increase loans at the expense of greater risk. The savings and loan industry suffered from loose lending with foreclosures and eventual government bailouts to protect depositors.

Today, many lenders have gone the other way and prefer to use very conservative appraisers. Some lender appraisals may vary significantly from appraisals commissioned by a loan broker.

LOANS IN EXCESS OF EQUITY (125% MORTGAGES)

These are second mortgages that exceed the home value by 25%. It is estimated that $10 billion in these loans were made in 1999. They are considered by some mortgage arrangers as a very hot product. While many of the larger mortgage companies will not touch these products, many mortgage brokers, including some of the larger ones, are actively seeking borrowers and lenders. In some cases, they are using boiler room techniques employing dozens of telemarketers.

Consumers are able to use proceeds to pay off relatively short term, high interest credit card debt at interest rates of up to 21% and substitute a second mortgage at 13 to 14% interest. This creates lower monthly payments for the borrower. In addition, the interest on the second mortgage will probably be deductible for income tax purposes while paid credit card interest is not deductible. The net effect is that the effective rate of interest for the borrower is lowered significantly.

These loans are risky to the purchaser in that borrowers who fail to cut up their credit cards are likely to get into trouble again. If foreclosure becomes necessary, the lender will have no security for funds lent in excess of the homeowner's equity.

A few mortgage–companies are making these loans and packaging them in large bundles. They are then sold on the secondary mortgage market. The large number of loans is believed to reduce the risk.

Investors should be made fully aware of the fact that loan funds in excess of borrowers' equity is in reality unsecured loans. These loans are likely being made to persons who, in the past, have spent themselves into debt which they could not handle.

CHARACTERISTICS OF HARD MONEY LOANS

HIGHER INTEREST RATES

☞ ***Loans made by hard money lenders bear interest rates higher than rates charged by institutional lenders.***

Risk is related to rate. No one will invest money in a higher risk investment unless the greater risk was compensated for in return. As an example, the most risk free long–term investment is government bonds which also provides the lowest rate of return of any long–term investment.

SHORTER TERMS

Loans made by hard money lenders are more likely to have a shorter repayment term than are loans made by institutional lenders.

NON–AMORTIZED

Loans made by hard money lenders are more likely to have a balloon payment than loans made by institutional lenders.

FIXED RATE

☞ ***Relatively few hard money loans have adjustable rates.***

The reason being that the interest rates are quite high to begin with, and hard money lenders who have a few loans do not want to be bothered with the accounting required to handle adjustable rate loans. (The loan could be serviced by a firm set up to handle adjustable rate loans.)

INVESTOR PROTECTION

As previously stated, the most important lending criteria for hard money lenders is the value of the property securing the loan.

☞ ***As a rule of thumb, the loan–to–value ratio should not exceed 70 percent.***

With a 70% ratio, the lender should not suffer a loss if the borrower defaults on his or her loan payments. The 30% equity should be sufficient to cover the following:

- **Interest Lost** – Payments not made means lost interest.
- **Foreclosure Costs** – Besides the direct costs of foreclosure, there is the time factor to consider. The time value of money (interest) must be considered.
- **Senior Liens** – It the investor's junior lien is in default, chances are the senior liens are also in default.
- **Marketing Costs** – Marketing costs to recoup the loss involve a number of expenses.
- **Commissions** – Costs paid to a sales agent.
- **Escrow and Closing Costs** – These are normal costs involved in any sale transaction.

- **Maintenance Costs** – The property will probably have maintenance costs during the marketing period. In addition, owners in foreclosure often neglect regular maintenance and in some case are actually destructive, which could result in considerable expense.

- **Holding Costs** – Depending on the type of property, it could take six months for a sale after foreclosure. To not suffer any loss, the sale proceeds should be enough to cover the taxes and insurance during this time period as well as the interest lost on the money the lender has invested. The interest will compound without the payments being made and with additional cash expenditures. Therefore, the actual lender investment has risen significantly.

  Of course, there is always the risk that values will decline and/or the loan appraisal was not realistic. This could result in the lender taking at significant loss as to sale price versus loan balance in addition to the other costs listed above.

The 70% ratio is close to a break–even ratio based upon a sale at appraisal value. If greater security is desired by a lender, the loan can either be reduced or additional assets can be added to the security. (Note that 125% loans violate the 70% rule).

ABILITY TO SERVICE DEBT

If a hard money equity lender lacks the financial ability to make the payments (service the senior loans) and maintain the property upon which the borrowers default, then that lender should not have been a lender.

Investors must consider the "What Its" of an investment. Investors are taking a huge risk if default would leave them owning on a property having loan obligations beyond their payment ability.

LOAN FILE RECORDKEEPING

At a very minimum, a hard money arranger should cover the following in his or her loan file.

- **Loan Application** – The application should include credit information. While these are not federally related loans, the Uniform Residential Loan Application is an excellent form to use.

- **Credit Report** – A copy of the credit report should be maintained in the file as well as a signed receipt from the lender that they received the credit information prior to funding the loan.

- **Verification of Mortgages** – Verification should be obtained as to balances on all senior encumbrances as well as on the status of senior loans.

- **Preliminary Title Report** – A Preliminary Title Report should be obtained and a copy retained in the loan file. A receipt from the lender showing receipt of the information should also be in the file.

- **Appraisal** – The file should include an appraisal by a licensed or certified appraiser.

☞***The broker is exposed to considerable liability if, as an arranger of the loan, he or she is also appraising the property.***

A subsequent foreclosure and resale at a significantly lower figure than the appraisal might result in a lawsuit. The lender could claim either negligence or fraud. However, if the arranger of the loan does make the appraisal, it should be well documented to stand a possible challenge by expert witnesses.

- **Mortgage Loan Disclosure Statement** – Copies of the Lender and Purchaser Mortgage Loan Disclosure Statement should be kept on file indicating, by the signatures of the parties, that the statements were received. Mortgage Loan Disclosure Statement will be discussed later in Chapter 11.

- **Servicing Agreement** – If the arranger of credit (Mortgage Loan Broker) will not service the loan, the file should have signed documentation that the lender was so informed.

☞***Most arrangers of mortgages do not service loans that they arrange.***

A few do so. These are usually multi–office loan brokers who have a significant volume and are able to treat loan servicing as a separate profit base.

If the hard money arranger will be servicing the loan, then the file should include a copy of the loan servicing agreement.

☞ ***Example:***

A prospective borrower entered into a written contract with a broker, where the broker was to obtain a $950,000 loan for the permanent financing of a shopping center.

The plaintiff broker obtained a loan commitment for the loan. However, the commitment introduced a condition not contemplated by the loan procurement agreement. As a condition of the loan, the lender required the limited partners to sign personally on the note and trust deed. This would override their exemption from liability, which was one of the purposes of being a limited partner.

The loan was refused on these conditions and the broker sued for a commission since a loan had been found.

The trial court held that the plaintiff had not performed as the offered loan had a condition that was reasonably unacceptable. The trial court was affirmed by the Court of Appeals.

CONVENTIONAL LOANS

Any loan that is not a government–backed loan is called a ***conventional loan****.* Government backed loans were discussed earlier in Chapter 5*.*

What does this mean? A conventional loan is *not guaranteed* or *insured* by an agency of the federal government. It may, however, be insured by a private mortgage insurance company, as discussed below. The guidelines for these conventional loans are set by the investor criteria, such as FNMA or FHLMC, covered in previous chapter.

Most lenders prefer to lend on single–family owner–occupied homes or condominiums. Conventional lenders, however, make loans not only on owner homes and one– to four–unit properties, but also on larger complexes. Property types that conventional lenders normally make loans on include larger apartment complexes, commercial shopping centers, office buildings, and industrial property. Just as many government lenders do not handle all programs, the same is true for conventional lenders, which often prefer to work with only certain types of conventional loan programs. No single conventional lender dominates the market; thus a mortgage loan broker may take a borrower's application file to more than one lender. If a loan is not approved by one lender, the mortgage loan broker may obtain approval at a second or third or fourth conventional lender, since each lender sets its own loan criteria.

In today's market, many mortgage loan companies have taken the lead in offering low down payment loans to qualified buyers. The typical down payment required on many of these loans ranges from 5 to 10%. Many loans also offer reduced loan origination fees and expanded debt–to–income ratios.

The advantages and disadvantages of conventional loans versus government–backed loans are outlined below.

Advantages of Conventional Loans

- **Processing time** – The processing time on a conventional loan is usually less than for a government insured or government–guaranteed loan. Under normal circumstances, the originator of the conventional loan has been given the underwriting guidelines of the investor and is allowed to approve any loan that, in the opinion of the originator, meets the guidelines. This is even true for conventional loans that are to be sold to Fannie Mae. This allows a lender to give in–house approval on Fannie Mae loans.

  The actual processing time for a conventional loan can take around 30 days, or sooner if all of the information to be verified is from local sources in an active real estate market. This can be protracted considerably.

  With automated (computerized) underwriting a conventional loan can be approved in as little as one week and even less. It is difficult to get that type of quick service from government programs. Usually, government agencies do not have the flexibility in their procedures that a conventional lender enjoys.

  This faster processing time is one of the major factors that will make the conventional mortgage more attractive to your clients.

- **Loan amounts** – Unlike government loans, the conventional loans or lenders have no set loan limits. This limit is usually set by the investor of the lender, unless the loan is sold off in the secondary market, as discussed in Chapter 7. But FHA sets maximum loan amounts on a home loan depending on geographical location. The DVA has no dollar loan maximum, but individual lenders do limit the veteran's loan amount because the DVA guarantees only part of the loan. Cal–Vet's maximum loan on a single–family dwelling is limited and can vary from year to year. Dollar limits on government–backed loans were covered in Chapter 5.

- **Flexibility of lenders** – When a lender keeps a loan, instead of reselling it in the secondary market, it is called a portfolio loan. Many portfolio lenders will make these loans with attractive provisions. Some may offer what is called the **"**Quick Qualifier**"** loan, requiring not much more than pay stubs to satisfy the verification requirements for loans with a large down payment. But even with very large down payments, the borrowers' credit is always checked.

- **More lenders available** – If you apply for a DVA–guaranteed loan and the loan is rejected by the DVA, you have no alternative lender. There is only one U.S. Department of Veterans Affairs, just as there is only a single FHA and one California Department of Veterans Affairs. On the other hand, if a loan is turned down by one conventional lender, there are other lenders who may approve the loan. No one conventional lender has a monopoly on the market: With different lenders come different underwriters and different attitudes, so that even though they are applying the same rules, results may differ due to compensating factors.

- **Less red tape** – Processing a conventional loan involves less red tape. There may be fewer forms to complete, and the routine of processing is more flexible.

Disadvantages of Conventional Loans

- **Higher down payments** – The down payment required on the conventional loan is more than that required on either the FHA or VA loan. Most buyers use government–backed financing because it usually requires a smaller down payment than conventional loans. DVA loans do not require any down payment (although a lender may require a down payment if there is a differential between sales price and appraisal); FHA and Cal–Vet require small down payments. However, during easy money markets, conventional loans with 3 to 10% down payments come close to competing with government loans for low down payments.

- **Prepayment penalties** – FHA, DVA, and Cal–Vet loans do not have a prepayment penalty. Some conventional loans have them, but they are becoming increasingly rare.

SOURCES OF CONVENTIONAL LOANS

The main sources of conventional money are mortgage bankers and mortgage companies, commercial banks, and savings banks.

Every lender has to adhere to certain state or federal agencies' regulations; but beyond that, what a lender does is a matter of company policy. For example, no regulation dictates what interest rate a lender should charge. That decision is up to the lender. Besides interest rate, there are many other financing terms and conditions for which each lender sets its own policy, based on market (business) judgments. Again it must be stressed that this applies only if the lender is making a loan that it is going to keep in its inventory, the so–called portfolio loan.

But if a conventional lender wishes to resell the loan to the ***Federal National Mortgage Association (Fannie Mae)*** or the ***Federal Home loan Mortgage Corporation (Freddie Mac),*** the lender must stick to standards established by these major loan purchasers.

BUY–DOWN MORTGAGE

A **buy–down mortgage** is a fixed–term, fixed–rate mortgage that has an effective interest rate below the note rate. It serves as a method of qualifying borrowers in a high–interest rate market by discounting the effective interest rate. This reduction is accomplished by the use of an impound account usually established by a builder and is sometimes referred to as a 3–2–1 or a step mortgage.

The reason for this type of mortgage is to lower the interest rate the borrower will pay in the first few years of the mortgage, especially the interest rate the borrower would pay in the first year of the mortgage. The importance of reducing the interest rate is that it will take less income for the borrower to qualify for the loan. It should be noted that the lender will receive the full principal and interest (P&I) payment as called for in the note, but there is no negative amortization because the difference between the payment made by the borrower and the amount received by the lender is taken from the impounded funds that are established at closing.

Buy–Down Period

What is meant by the buy–down period? This is the period that the borrower will be paying an interest rate below the note rate. There is no fixed buydown period. It can be as short as 3 years or as long as 10 years, but many of those who purchase mortgages in the secondary market have limited the period to 3 years.

Buy–Down Interest Rate

Many times the real estate professional will see the buy–down advertised as 3–2–1, which means that the first year's effective interest rate to the borrower or the rate that will be used to qualify the borrower will be three percentage points below the market rate offered by the lender. Thus, the second year the rate on the borrower's effective rate would be two points below the rate on the note; and finally in the third year of the mortgage, the borrower would be paying an effective rate of 1 percent below the rate on the note. Thus, with this type of mortgage, the borrower would not pay the full note rate until the 37th payment or at the beginning of the fourth year. Why is it important to lower the first–year interest rate? This is the rate the lender will use to qualify the borrower.

In late 1983 and early 1984, many builders and lenders started to offer *deep buy–downs* extending over 5 to 10 years. For example, a builder might offer an 8–6–4–2 buy–down. Many of the mortgage insurers and purchasers of mortgages in the secondary market felt that this deep payment level may in a few years expose the borrower to payment shock. Under this program, the borrower would be qualified at a rate eight percentage points below the note rate. Let us assume the note rate was 13.250; the borrower would be qualified at 13.250 percent less 8 percent or 5.25 percent. This rate would increase in the second year to 13.250 less 6 percent or 7.25 percent and so on through the 4–year buy–down period.

Many of those who either buy mortgages in the secondary market or insure conventional mortgages have set the maximum buy–down that may be used to quality the borrower as three below the rate expressed on the note regardless of the amount of the actual buy–down.

☞ ***In the current low interest rate era of the 2002s, this device is seldom used except in FHA/DVA discounting.***

CALCULATION OF BUY–DOWN FUNDS

In this section we will review the methods that may be used to calculate the funds necessary to secure a temporary payment reduction for a client.

One question that always is asked is who may pay the payment reduction funds? According to many lenders as well as the FHA and the DVA, the funds can be provided by anyone. Most lenders will not require a gift letter from the borrower if a third party should provide a portion of the buy–down funds. The buy–down funds are in addition to any other discount points or any other fee in connection with the loan.

Now let us assume we are working with a client–either the buyer or seller–and that the client is interested in a buy–down mortgage. The mortgage amount will be $86,550 with a term of 30 years and an interest rate of 10 percent. First we will need to calculate the monthly payment for the mortgage at 10 percent. This can be done by consulting Appendix A and finding the monthly payment factor for a 30–year loan at 10.00. We then multiply the monthly payment factor, 8.7757, by the loan amount expressed in thousands or

8.7757 X 86.55 / 1,000 = $759.54 (P&I)

This will be the amount of the *P* & I payment the lender will receive each month, irrespective of the amount the borrower pays.

The second step is to calculate the interest rate the borrower will be paying for each of the 3 years.

Year 1 of the buy–down is the note rate less 3 percent or 10.00 – 3 = 7.00

This will be the rate that will be used to qualify the borrower.

Year 2 is the note rate less 2 percent or, 10.00 – 2 = 8.00

Year 3 is the note rate less 1 percent or 10.00 – 1 = 9.00

The third step is to calculate the actual dollars that will be required to fund or to be impounded to supplement the borrower's payment to the level required by the lender or $759.54. This amount may be calculated using two different methods. One method is sometimes referred to as the fast–and–dirty method. Using this method, we add up the percent of buy–down each year, in this case 3 + 2 + 1 or a total of 6 percent. This amount is then multiplied by the loan amount of the loan amount is multiplied by each of the percentages.

$86,550 X 3%=	*$2596.50*
$86,550 X 2%=	*$1731.00*
$86,550 X 1% =	*$865.50*
Total required	*$5193.00*

The second method used to calculate the buy–down funds is sometimes referred to as the *actual cash method.* With this method, the actual difference between the monthly payment made by the borrower and the monthly payment required by the lender is calculated for each year of the buy–down. This would be calculated as follows:

Year 1
Interest rate paid by borrower:7.00
Monthly payment of borrower: $575.82
Monthly payment required by lender:$759.54
Difference between payments:$759.54 – $575.82 = $ 183.72X12 = $2204.64

Year 2
Interest rate paid by borrower:8.00
Monthly payment of borrower: $635.07
Monthly payment required by lender: $759.54
Difference between payments: $759.54 – $635.07= $124.4 X12 = $1493.64

Year 3
Interest rate paid by borrower:9.00
Monthly payment of borrower: $696.40
Monthly payment required by lender: $759.54
Difference between payments: $759.54 –$696.40 = $63.14 X12 = $757.68

Total funds required:
$2204.64+$1 493.64+$757.68 = $4455.96

You will note there is a difference between the two figures of approximately $737.04. The supplier of the buy–down funds, therefore, would seek a lender that calculates the buy–down funds using the actual cash method.

LOW DOWN PAYMENT CONVENTIONAL LOANS

Both the Federal National Mortgage Association and the Federal Home loan Mortgage Corporation recognize that accumulating a down payment and the required closing costs keeps many people from buying a home. To help this situation, both have created several low down payment programs. Although there are minor differences between Fannie Mae and Freddie Mac, the gist of the popular Fannie/ Freddie 97 programs is as follows:

- A down payment of only 3% is required, meaning a 97% loan–to–value (LTV) loan is granted.
- Income qualifying ratios are easier. Borrowers must have an excellent credit history.
- Borrowers must attend a home buyer educational seminar.
- In some cases there may be an income level requirement for the borrower (these limits are more generous in California than in most other states).
- The loan can be used to buy only single–family, principal residences, including condos, planned unit developments, and manufactured homes attached to a permanent foundation.

Another popular Fannie Mae/Freddie Mac offering is called the ***Community Home Buyer's Program.*** This plan is designed especially to help low– and moderate–income home buyers and features what is called the 3/2 option. The 3/2 Option provides for a low 5% down payment, but with a twist. It allows borrowers to put only 3% of their own money toward a down payment. The other 2% may be obtained from family gifts or by means of a grant or loan from the state, a local government agency, or a nonprofit organization.

Traditional credit standards are required, but other underwriting criteria are eased to qualify applicants, with greater emphasis on stable job history, steady rent and utility payments, and a ceiling on the qualifying income level, since the program is limited to those less affluent. Though creditworthiness is always important, a greater percentage of applicants' gross monthly income may be used to meet mortgage payments. Because of the high loan–to–value ratio, the 3/2 option loans must be covered by private mortgage insurance, discussed later. But with what amounts to 97% financing, coupled with reduced closing costs and cash reserve requirements, more families may find the dream of home ownership affordable.

PRIVATE MORTGAGE INSURANCE

Private mortgage insurance may be defined as an insurance policy issued from a licensed company to an approved lender, protecting that lender from financial loss due to the default of a borrower. This insurance is issued only on first–lien mortgages secured by improved residential property. Usually the insurance is only issued on mortgages that exceed 80 percent of the appraised value of the property.

☞ ***PMI has become a viable alternative to FHA insurance.***

PMI COVERAGE

TYPES OF PROPERTIES

As a real estate professional, you should have knowledge of the types of properties and the amount of insurance available. All PMI companies will normally issue policies on first–lien mortgages on a one– to four–family dwelling used as a primary residence where the loan does not exceed 95 percent of the appraised value. Some PMI companies will issue mortgage insurance on a mortgage for a second home or a leisure home. In this case, the loan may not exceed 80 percent of the appraised value. Some PMI companies will issue insurance on mortgages of one– to four–family dwellings that are not the primary residence, but are held as investment property. For the investment property, the loan–to –value ratio generally should not exceed 80 percent. Not only will PMI companies issue insurance on single family dwellings, but some of the companies will issue mortgage insurance on manufactured housing. To get the details on this coverage, you will have to contact the various PMI companies to see if they issue this type of insurance. Due to losses recently suffered in the industry based upon improper appraisal techniques and poor underwriting, PMI companies are establishing stricter guidelines in the areas of negative amortized loans and accepting insurance applications on condominiums and planned unit developments.

INSURANCE ISSUED

Many references have been made to issuance of insurance by the PMI company on mortgages, but what is the coverage of the insurance? First, it should be made very clear that PMI insurance is not the same as the insurance issued by FHA. PMI does not insure 100 percent of the mortgage, but only a portion of the mortgage. What portion of the mortgage is insured? The PMI companies are limited by law to the maximum percent of the loan they can insure.

The normal protection for a fixed–term, fixed rate mortgage is between 20 and 30 percent, and for an adjustable–rate mortgage the coverage is between 20 and 35 percent. This protection is available on a high loan–to–value ratio loan of 80 percent or more and issued almost exclusively on 90 to 95 percent loans. With this type of coverage available, institutions that are limited to a maximum loan–to–value ratio of 75 percent are able to make 95 percent loans. With the 25 percent coverage on a fixed–term, fixed–rate 95 percent loan on a home selling for $70,000, the lender would have the following risk:

Sales price	$70,000
Loan amount–95 %	$66,500
Borrower's down payment	$ 3,500
Loan amount	$66,500
PMI Coverage	X25%
Total PMI coverage	$16.625

Thus, the lender's exposure on the property would be the sales price, less the down payment, less the insurance coverage, or:

$70,000 – $3,500 –$16,625 = $49,875

When the items are subtracted from the sales price and the lender's exposure of $50,000 is divided by the sales price, the lender is actually making a 71.25 percent loan.

$48,875 / $70,000 = 71.25%

In addition to the 25 percent coverage on the fixed–rate loans, many of the PMI companies offer 12–, 16–, 17–, 20–, 22–, 25–, and 30–percent coverage. In regard to the adjustable–rate mortgage, many of the companies offer 20–, 25–, 30–, and 35–percent coverage.

These are the standard coverage's that many of the lenders will require on many of the loans they originate or fund. If the mortgage is to be sold to Fannie Mae or FHLMC, however, the required overages are as follows:

Fixed–rate mortgage

91 to 95% loans	22% coverage
86 to 90% loans	17% coverage
81 to 85% loans	12% coverage
80% and under	No coverage

Loans with possible negative amortization

91 to 95% loans	25% coverage
All other loan/value ratios	20% coverage

One can see that normally Fannie Mae and FHLMC require less coverage, thus increasing the lender's exposure slightly.

Let us use the same example as before and calculate the lender's exposure to loss through Fannie Mae or FHLMC.

Sales price	$70,000
Loan amount–95 %	$66,500
Borrower's down payment	$ 3,500
Loan amount	$66,500
PMI Coverage	X22%
Total PMI coverage	$14,630

Once again, the lender's exposure to loss would be the sales price, less the down payment, less the PMI coverage or–

$70,000 – $3,500 – $14,630 = $51,870

This would have the lender actually making a 74.1 percent loan, increasing the lender's exposure by less than 3 percent.

The coverages discussed above are only the basic coverages and many are available. You as a real estate professional, however, will normally deal only with the coverages outlined above.

PMI PREMIUMS

PMI companies' operations and rates are monitored by the Insurance Commissioner of the State of California. Competition, however, keeps them relatively uniform from the issuing companies.

Generally, PMI companies insure loans on one to two units up to 97% and on three to four units up to 90 percent. Figures can vary from company to company and the following examples are for illustration purposes only.

1. **Loans over 80 and up to 85% loan–to–value coverage** – The insurance ordinarily covers the top 12% of the loan amount. To keep it simple, if a home sold for $100,000 and the loan was 85% or $85,000, the coverage would be 12% of $85,000 = $10,200. The lender's exposure is $74,800, or 75 percent.

   - **Premiums** – If annual premiums are utilized, the fee due at close of escrow would be about .29% of $85,000, or about $246, and monthly collections thereafter would be $20.54. If *monthly* premiums are utilized, there may be no advance collection at close of escrow, and the premiums based on .32% would be $22.67.

2. **Loans above 85 and up to 90% loan–to–value coverage** – the insurance ordinarily covers the top 25% of the loan amount. If a home sold for $100,000 and the loan was 90% or $90,000, the coverage would be 25% of $90,000 = $22,500. Lender's exposure is $67,800 or 68 percent.

   - **Premiums** – If annual premiums are utilized, the fee due at close of escrow would be about .49% of $90,000, or about $441, and monthly collections thereafter would be $36.75. If monthly premiums are utilized, there may be no advance collection at close of escrow, and the premiums based on .52% would be $39.

3. Loans above 90 and up to 97% loan–to–value coverage – The insurance ordinarily covers the top 30% of the loan amount. If a home sold for $100,000 and the loan was 95% or $95,000, the coverage would be 30% of $95,000 = $28,500. Lender's exposure is $66,500 or 67 percent.

   - **Premiums***:* If annual premiums are utilized, the fee due at close of escrow would be about .75% of $95,000, or about $712, and monthly collections thereafter would be $59.38. If *monthly* premiums are utilized, there may be no advance collection at close of escrow, and the premiums based on .78% would be $61.75.

There are other variations of fees and annual premiums, as welt as plans whereby you can pay one fee at the time of closing and no annual premium. Whether premiums are paid on the basis of 1/12 of an annual premium or merely on a monthly premium basis, the amounts are ordinarily collected by the lender with monthly impounds of taxes and insurance.

Some lenders will, as an alternative, insure the loan using PMI that the lender pays for by increasing its loan interest rate. In this circumstance, the lender's quoted rate includes the PMI premiums, but since it is, in fact, an interest rate, it is deductible under IRS rules. If the lender charges an interest rate plus the PMI premium, then only the interest is deductible, and the insurance premium is not.

Offsetting this advantage or disadvantage (depending upon how long the borrower resides in the property) is the fact that when the lender includes the PMI in its rate, the payments will never change, even when the loan–to–value drops below 80% and the PMI coverage is dropped. At that point, the lender's yield increases by the amount of premium no longer paid. On the other hand, when the tender charges a rate plus a premium, the borrower's payment will decrease when loan–to–value declines to 78% or below, and PMI is no longer required. For short–term ownership, being able to deduct it all as interest may be advantageous. For long–term ownership, the likelihood that payments will someday decrease may be the better choice.

In California, the Civil Code allows residential borrowers to cancel PMI after two years if the loan–to–value ratio is 78% of the current market value. But better yet, under federal law, for all new insured loans originated after January 1999, all lenders on FHA insured loans must cancel the MIP coverage when there is at least a 22% home equity. This 22% equity must be shown by an official appraisal, the borrower must have a good payment history, and the loan must be on the books for at least two years.

Appreciation, not just principal pay down, counts to measure the 22% or more equity. Special note: Both the California and federal laws cover only new insured loans granted from January 1998 for the state law, and January 1999 for the federal law, but not loans already on record prior to those dates. In both cases, FHA mortgage insurance (MIP) cannot be cancelled.

APPLICATION FOR PMI

Each of the PMI companies has its own procedures for the application of coverage. Usually the lender will submit a completed loan package to the PMI company. Using the form of the investor or those supplied by the PMI company, the PMI company will review the materials and approve or disapprove the borrower based on the materials.

Normally the PMI companies will have standard underwriting guidelines concerning the relationship of the total monthly income to the total mortgage payment, including all escrows and any fees that may affect the title to the property. In addition to the ratio of the total monthly income to mortgage payment, the PMI companies will review the ratio of the total monthly income to the total long–term obligations of the borrower, including the total mortgage payment. In most cases, the PMI companies define *long–term obligation* as any obligation that will take 10 or more months to pay off.

The PMI company will review the credit history of the borrower, his and/or her work record, and any other factor that may affect the borrower's ability or willingness to repay the obligations. Some of these factors are court judgments, pending lawsuits, and bankruptcy.

The PMI company will also review the property that will serve as the security for the mortgage. The economic life of the property will be checked to see if it is sufficient to support the term of the loan. Also considered is whether the property can be sold rapidly if it is taken back, and whether it is an existing construction or proposed construction. These are only a few of the guidelines used by the PMI companies. If you would like further information, you may contact a PMI company and they will be able to supply you with the in–depth underwriting guidelines they use.

If all of the underwriting guidelines are met and the PMI company will issue the requested coverage, the originating lender will be notified by phone, and later a written confirmation of the approval will be furnished. This underwriting procedure will normally take only 1 or 2 days. One can see that the underwriting by the PMI companies is a great deal faster than that of FHA, which can take many weeks.

CLAIMS PAYMENT

When a lender has notified the PMI company that an insured loan is in default as per the procedures of the PMI company, the insuring company has two ways of handling the claim. First, the company can pay the lender the full amount of the remaining loan balance. If this is done, the PMI company will take title to the property and then dispose of the property. Second, the PMI company can pay the lender as per the coverage purchased (20, 25, or 10 percent of the loan balance) plus other expenses in the policy of the PMI company, and the lender will then dispose of the property.

Claims under insurance issued by a PMI company are handled differently from claims filed against FHA mortgage insurance. The FHA will pay the lender the outstanding loan balance either in cash or debentures secured by the United States Treasury and FHA will take the property.

If a foreclosure occurs on a property that is insured, the PMI company either:

- Pays off the lender in full and takes title to the property, or
- Pays the lender in accordance with the insurance, usually 20 to 25% of the principal balance plus certain expenses. The lender then keeps the property and is responsible for selling it.

BENEFITS OF PMI COVERAGE

There are many benefits for both the borrower and the lender with the purchase of PMI coverage.

- Advantages to the lender –
  1. The PMI insurance allows the lender to make 90 and 95 percent loans and to sell these loans in the secondary market.
  2. With the ability to make higher loan-to-value ratio loans, the amount of possible loans is expanded.
  3. The lender can secure an additional amount of security for the loan at no extra cost.
  4. The processing time and the issuance of the insurance commitment is usually faster from a PMI company than the FHA.
- Advantages for the borrower –
  1. The borrower has the ability to purchase a home with a conventional loan with as little as 5 percent down payment.
  2. With the need for less money down, the borrower can buy a home sooner and sometimes larger than expected.

3. The processing time for the insurance commitment is usually faster than with the FHA.

4. The payment of the insurance premiums is for a shorter period than FHA.

CHAPTER QUIZ

1. Which of the following would be a hard money loan?

    A. A purchase money loan made by an institutional lender
    B. Seller carryback financing
    C. Assuming existing loans with no balance
    D. A loan arranged by a mortgage loan broker

2. The most important criteria used by lenders of hard money loans would be the borrowers:

    A. Equity
    B. Credit history
    C. Job
    D. History

3. Reasons why institutional lenders turn down loan applications could deal with:

    A. Borrowers capacity to make payments
    B. Borrower's credit history
    C. The type of property the loan is sought on
    D. All of the above

4. Characteristics of hard money loans, as compared with loans made by institutional lenders, are:

    A. Shorter terms
    B. Higher rate of interest
    C. Non–amortized
    D. All of the above

5. Hard money lending is not without risk. Risks include:
   A. Foreclosure costs
   B. Costs associated with delinquent senior liens
   C. Marketing costs after foreclosure
   D. All of the above

6. A non–government–backed loan is best known as a loan.

   A. Portfolio
   B. Standard
   C. Conventional
   D. Normal

7. Private mortgage insurance covers what portion of the loan amount?

   A. Upper portion of the loan
   B. Middle portion of the loan
   C. Lower portion of the loan
   D. Entire loan

8. A straight conventional loan includes

   A. FHA insurance.
   B. A DVA guaranty.
   C. A private mortgage insurance agreement.
   D. No third party insurance or guarantees.

9. If a PMI–backed conventional loan is foreclosed, the insurer may

   A. Pay the lender the full amount of insurance.
   A. Pay off the lender in full and take over the property.
   C. Either A or B.
   D. Neither A nor B.

10. Chances are that you would get the lowest loan to value ration loan using:

   A. FHA financing
   B. A VA loan
   C. A Cal-Vet loan

D. Conventional financing

Answer Key: 1–A, 2–C, 3–B, 4–B, 5–B, 6–D, 7–C, 8–C, 9–D, 10–C

CHAPTER 7: LOAN PAYMENTS & SECONDARY MARKETS

PREVIEW

This chapter covers the types of mathematical concepts most applicable to the real estate financing process. We will differentiate between a straight note and an amortized note. We will also discuss the secondary market activities. Mortgage loan brokers are engaged in the primary mortgage market when they are making the loan and in the secondary mortgage market when they are in the business of selling the loan.

LOAN PAYMENT CHARACTERISTICS

A loan can be repaid in various ways – all at once, in equal installments, or by some other method. In most cases there will be interest as well as principal to be repaid.

AMORTIZED LOAN

A loan which is amortized will have equal periodic payments, which are calculated to pay off the loan in full at the end of the term. Level payment plan is another name for an amortized loan. Monthly payments include both principal and interest. Interest is computed on the unpaid principal balance.

☞ ***Example***

A borrows $5,000 from B to be repaid over 5 years, at 14% interest with monthly payments to include both principal and interest on a fully amortized basis. Monthly payments of $116.35 (from amortization table or financial calculator) will be made for 60 months or 5 years, at which time the loan and interest will be fully paid.

monthly payment months paid	$116.35
principal & interest	$6,981
principal	-$5.000
total interest paid	$1,981

Interest is calculated from month to month on the unpaid principal balance (simple interest).

Loan Term – The length of the loan can vary, typically from 3 to 30 years. For the same amount of money, the longer the term of the amortization, the smaller the amount of each periodic payment, although terms beyond 30-years provide very little reduction in payments.

Many borrowers now are opting for 15–year amortization periods–a plan which greatly reduces total interest costs.

☞ ***Example***

Compare the results of a $150,000 loan amortized over 30– and 15–year periods at the same 10% interest rate.

Term	*Monthly Payment*	*Total of Payments*	*Total Interest*
30 years	*$1,316.36*	*$473,889*	*$323,889*
15 years	*$1,611.91*	*$290,143*	*$140,143*

PARTIALLY AMORTIZED

Also referred to as a ***"balloon payment"*** loan. Monthly payments cover interest and some of the principal, but are not large enough to repay all of the principal during the term of the loan.

- **Balloon Payment** – In a partially amortized loan, the last payment calls for all the remaining principal balance due (balloon payment). The California Real Estate law, where applicable, defines a balloon payment as one "greater than twice the amount of the smallest installment."

- **Interest** – Interest is computed on the unpaid balance.

7: LOAN PAYMENTS & SECONDARY MARKETS

STRAIGHT NOTE

Also refereed to as **"interest only."** Only the interest is paid during the life of the note. The entire principal is due at the end of the loan term. The dreaded "mortgage" of old–fashioned melodrama was a straight note.

☞ *Example*

A borrows $2,000 from B for a two–year period. The interest rate is 12% per annum, payable quarterly, with the entire principal due and payable at the end of the two–year term.

Payments would be made as follows:

1st Year		*2nd Year*	
end 1st qtr.	*$60*	*end 1st qtr.*	*$60*
end 2nd qtr.	*$60*	*end 2nd qtr.*	*$60*
end 3rd qtr.	*$60*	*end 3rd qtr.*	*$60*
end 4th qtr.	*$60*	*end 4th qtr.*	*$2,060*

(All interest and principal is paid in full.)

NEGATIVE AMORTIZATION

If the monthly payment is less than the amount due for the monthly interest, the amount of the deficiency is added to the principal debt. This circumstance is most likely to occur with an adjustable rate mortgage (ARM) with a payment cap.

AMORTIZATION TABLE

Amortization table is not a simple percentage calculation. It is normally derived from tables which summarize a complex arithmetic, or it can be calculated using a computer or calculator with amortization capacity. The amortization tables on next page give the numbers applicable to a $1,000 loan at various interest rates and various times. A full book of amortization tables would give the figures for loans of different amounts, making the loan amount in the fourth variable. The four variables used in compiling the tables are loan amount, interest rate, loan term, and monthly payment. Below is the procedure for finding one factor when the other three are given.

TO DETERMINE PAYMENT

An $11,000 loan is to be amortized over a period of 18 years with 14% interest. What would be the approximate monthly payment?

Locate the term of the loan in the first vertical column, 18 years, then proceed across to the appropriate interest rate column (14%). The figure at the intersection ($12.70) indicates the monthly payment per $1,000 of loan. For a loan of $11,000, multiply $12.70 x 11 = $139.70 per month (principal and interest).

TO DETERMINE INTEREST RATE

A $10,000 loan is to be amortized over seven years with monthly payments of $176.60. What is the annual interest rate?

Find the monthly payment per $1,000 by dividing the monthly payment of $176.60 by 10 which equals $17.66. Go down the column to 7 years, across to 17.66, and up to 12%.

TO DETERMINE INTEREST PAID

A $14,000 loan is to be amortized over 20 years with equal monthly payments which included 13% interest. Approximately how much interest will be earned by the lender?

Determine the monthly amortization payment: down term of years to 20; across to the 13% interest rate column to $11.72, multiply 14 (thousands) x $11.72 = $164.08 per month. Determine the total interest paid: 20 years x 12 months = 240 payments made; 240 payments x 164.08 per month = $39,379.20. Total interest paid less amount of original loan equals the approximate interest earned ($39,379.20 – $14,000.00) = $25,379.20

Figure 7-1 Amortization Table

TABLE OF MONTHLY PAYMENTS TO AMORTIZE $1,000 LOAN

Terms of years	5%	5.5%	6%	6.5%	6.6%	7%	7.5%	8%	8.25%	8.5%	8.75%	9%	9.25%	9.5%	9.75%	10%
5	18.88	19.11	19.34	19.57	19.62	19.81	20.04	20.28	20.40	20.52	20.64	20.76	20.88	21.01	21.13	21.25
6	16.11	16.34	16.58	16.81	16.86	17.05	17.30	17.54	17.66	17.78	17.90	18.03	18.15	18.28	18.40	18.53
7	14.14	14.38	14.61	14.85	14.90	15.10	15.34	15.59	15.71	15.84	15.96	16.09	16.22	16.35	16.47	16.61
8	12.66	12.90	13.15	13.39	13.44	13.64	13.89	14.14	14.27	14.40	14.52	14.66	14.78	14.92	15.04	15.18
9	11.52	11.76	12.01	12.26	12.31	12.51	12.77	13.02	13.15	13.28	13.41	13.55	13.68	13.81	13.94	14.08
10	10.61	10.86	11.11	11.36	11.41	11.62	11.88	12.14	12.27	12.40	12.53	12.67	12.80	12.94	13.08	13.22
11	9.87	10.12	10.37	10.63	10.68	10.89	11.15	11.42	11.55	11.69	11.82	11.97	12.10	12.24	12.38	12.52
12	9.25	9.51	9.76	10.02	10.08	10.29	10.56	10.83	10.96	11.11	11.24	11.39	11.52	11.67	11.81	11.96
13	8.74	8.99	9.25	9.52	9.57	9.79	10.06	10.34	10.47	10.62	10.75	10.90	11.04	11.19	11.33	11.48
14	8.29	8.55	8.82	9.09	9.14	9.36	9.64	9.92	10.06	10.20	10.34	10.49	10.64	10.79	10.93	11.09
15	7.91	8.17	8.44	8.72	8.77	8.99	9.28	9.56	9.70	9.85	10.00	10.15	10.29	10.45	10.59	10.75
16	7.58	7.85	8.12	8.40	8.45	8.63	8.96	9.25	9.40	9.55	9.69	9.85	10.00	10.15	10.30	10.46
17	7.29	7.56	7.84	8.12	8.17	8.40	8.69	8.99	9.13	9.29	9.44	9.59	9.74	9.90	10.05	10.22
18	7.04	7.31	7.59	7.87	7.93	8.16	8.45	8.75	8.90	9.06	9.21	9.37	9.52	9.68	9.84	10.00
19	6.81	7.08	7.37	7.65	7.71	7.95	8.25	8.55	8.70	8.86	9.01	9.17	9.33	9.49	9.65	9.82
20	6.60	6.88	7.17	7.46	7.52	7.76	8.06	8.37	8.52	8.68	8.84	9.00	9.16	9.33	9.49	9.66
21	6.42	6.70	6.99	7.29	7.35	7.59	7.90	8.21	8.36	8.53	8.68	8.85	9.01	9.18	9.34	9.51
22	6.26	6.54	6.84	7.13	7.19	7.44	7.75	8.07	8.22	8.39	8.55	8.72	8.88	9.05	9.21	9.39
23	6.11	6.40	6.69	7.00	7.06	7.30	7.62	7.94	8.10	8.27	8.43	8.60	8.76	8.93	9.10	9.28
24	5.97	6.27	6.56	6.87	6.93	7.18	7.50	7.83	7.99	8.16	8.32	8.49	8.66	8.83	9.00	9.18
25	5.85	6.15	6.45	6.76	6.82	7.07	7.39	7.72	7.88	8.06	8.22	8.40	8.56	8.74	8.91	9.09
26	5.74	6.04	6.34	6.65	6.72	6.97	7.30	7.63	7.79	7.96	8.14	8.31	8.48	8.66	8.83	9.01
27	5.64	5.94	6.24	6.56	6.62	6.88	7.21	7.55	7.71	7.88	8.06	8.23	8.41	8.58	8.76	8.94
28	5.54	5.84	6.16	6.48	6.54	6.80	7.13	7.47	7.64	7.81	7.99	8.16	8.34	8.52	8.70	8.88
29	5.45	5.76	6.08	6.40	6.46	6.73	7.06	7.40	7.57	7.75	7.92	8.10	8.28	8.46	8.64	8.82
30	5.37	5.68	6.00	6.33	6.39	6.66	7.00	7.34	7.51	7.69	7.87	8.05	8.23	8.41	8.59	8.78
35	5.05	5.38	5.71	6.05	6.13	6.39	6.75	7.11	7.29	7.47	7.65	7.84	8.03	8.22	8.41	8.60
40	4.83	5.16	5.51	5.86	5.93	6.22	6.59	6.96	7.14	7.33	7.52	7.71	7.91	8.10	8.30	8.49

TABLE OF MONTHLY PAYMENTS TO AMORTIZE $1,000 LOAN (Cont'd)

Term of Years	10%	10.25 %	10.5%	10.75 %	11%	11.25 %	11.5%	11.75 %	12%	12.25 %	12.5%	12.75 %	13%	13.25 %	13.5%	14%	15%
5	21.25	21.37	21.49	21.62	21.74	21.87	21.99	22.12	22.25	22.37	22.50	22.63	22.75	22.88	23.01	23.27	23.79
6	18.53	18.65	18.78	18.91	19.04	19.16	19.29	19.42	19.55	19.68	19.81	19.94	20.07	20.21	20.34	20.61	21.15
7	16.61	16.73	16.86	16.99	17.12	17.25	17.39	17.52	17.65	17.79	17.92	18.06	18.19	18.33	18.47	18.74	19.30
8	15.18	15.31	15.44	15.57	15.71	15.84	15.98	16.12	16.25	16.39	16.53	16.67	16.81	16.95	17.09	17.37	17.95
9	14.08	14.21	14.35	14.49	14.63	14.76	14.90	15.04	15.18	15.33	15.47	15.61	15.75	15.90	16.04	16.33	16.92
10	13.22	13.35	13.49	13.63	13.78	13.92	14.06	14.20	14.35	14.49	14.64	14.78	14.93	15.08	15.23	15.53	16.13
11	12.52	12.66	12.80	12.95	13.09	13.24	13.38	13.53	13.68	13.83	13.98	14.13	14.28	14.43	14.58	14.89	15.51
12	11.96	12.10	12.24	12.39	12.54	12.68	12.83	12.98	13.13	13.29	13.44	13.59	13.75	13.90	14.06	14.37	15.01
13	11.48	11.63	11.78	11.92	12.08	12.23	12.38	12.53	12.69	12.84	13.00	13.15	13.31	13.47	13.63	13.95	14.60
14	11.09	11.23	11.38	11.54	11.69	11.85	12.00	12.16	12.31	12.47	12.63	12.79	12.95	13.11	13.28	13.61	14.27
15	10.75	10.90	11.05	11.21	11.37	11.52	11.68	11.84	12.00	12.16	12.33	12.49	12.65	12.82	12.98	13.32	14.00
16	10.46	10.62	10.77	10.93	11.09	11.25	11.41	11.57	11.74	11.90	12.07	12.23	12.40	12.57	12.74	13.08	13.77
17	10.22	10.37	10.53	10.69	10.85	11.02	11.18	11.35	11.51	11.68	11.85	12.02	12.19	12.36	12.53	12.87	13.58
18	10.00	10.16	10.32	10.49	10.65	10.82	10.98	11.15	11.32	11.49	11.66	11.83	12.00	12.18	12.35	12.70	13.42
19	9.82	9.98	10.14	10.31	10.47	10.64	10.81	10.98	11.15	11.33	11.50	11.67	11.85	12.03	12.20	12.56	13.28
20	9.66	9.82	9.98	10.15	10.32	10.49	10.66	10.84	11.01	11.19	11.36	11.54	11.72	11.89	12.07	12.44	13.17
21	9.51	9.68	9.85	10.02	10.19	10.36	10.54	10.71	10.89	11.06	11.24	11.42	11.60	11.76	11.96	12.33	13.07
22	9.39	9.55	9.73	9.90	10.07	10.25	10.42	10.60	10.78	10.96	11.14	11.32	11.50	11.69	11.87	12.24	12.99
23	9.28	9.44	9.62	9.79	9.97	10.15	10.33	10.51	10.69	10.87	11.05	11.23	11.42	11.60	11.79	12.16	12.92
24	9.18	9.35	9.52	9.70	9.88	13.06	10.24	10.42	10.60	10.79	10.97	11.16	11.34	11.53	11.72	12.10	12.86
25	9.09	9.26	9.44	9.62	9.80	9.98	10.16	10.35	10.53	10.72	10.90	11.09	11.28	11.47	11.66	12.04	12.81
26	9.01	9.19	9.37	9.55	9.73	9.91	10.10	10.28	10.47	10.66	10.84	11.03	11.22	11.41	11.60	11.99	12.76
27	8.94	9.12	9.30	9.49	9.67	9.85	10.04	10.23	10.41	10.60	10.79	10.98	11.17	11.37	11.56	11.95	12.73
28	8.88	9.06	9.25	9.43	9.61	9.80	9.99	10.18	10.37	10.56	10.75	10.94	11.13	11.32	11.52	11.91	12.70
29	8.82	9.01	9.19	9.38	9.57	9.75	9.94	10.13	10.32	10.52	10.71	10.90	11.09	11.29	11.48	11.88	12.67
30	8.78	8.96	9.15	9.33	9.52	9.71	9.90	10.09	10.29	10.48	10.67	10.87	11.06	11.26	11.45	11.85	12.64
35	8.60	8.79	8.98	9.18	9.37	9.56	9.76	9.96	10.16	10.35	10.55	10.75	10.95	11.15	11.35	11.76	12.57
40	8.49	8.69	8.89	9.08	9.28	9.48	9.68	9.88	10.09	10.29	10.49	10.69	10.90	11.10	11.30	11.71	12.53

LOAN COSTS

The largest and most obvious cost of a loan is interest. In addition to interest, a real estate loan will involve various administrative costs, deposits, and additional fees.

INTEREST

Interest is money paid to a lender for use of the lender's money. It is usually defined as a percentage of the amount borrowed.

SIMPLE AND COMPOUND INTEREST

- **Simple interest** is the percentage charged on the unpaid principal.
- **Compound interest** is interest on principal and *accrued interest.* The nominal rate (percentage) is specified in the promissory note.
  - Forces Influencing Interest Rates – Interest rates fluctuate depending upon demand and availability of the money supply and other factors. Interest rates are limited by law for some government programs.

INTEREST CALCULATIONS

The formula for interest calculations is:

☞ ***Interest = Principal x Time x Rate or I = P x R x T***

☞ ***Example:***

How much interest will be paid in 2 years on a straight loan of $100,000 at 10% for 3 years?

I = P x R x T = $100,000 x .10 x 2 = $20,000

☞ ***Example:***

What is the annual rate of interest on a straight note with a principal amount of $1,200 on which $240 interest has been paid over a 2 years?

R = I / P x T = $240 / 1200 x 2 = .10 or 10%

☞ ***Example:***

For how many years is a note with a principal of \$1,000 total interest of \$360 paid at a rate of 12% annually?

T = I / P x R = \$360 / \$1,000 x .12 = 3 years

☞ ***Example:***

What is the principal amount of a straight note on which \$5,750 of interest has been paid over 5 years at a rate of 11.5%?

P = I / R x T = \$5750 / .115 x 5 = \$10,000

ORIGINATION FEES OR POINTS

Most lenders require these initial fees to set up loan accounts. One point equals 1% of the loan amount, a nonrecurring cost (one time charge).

IMPOUND ACCOUNT

This is a reserve account for taxes and insurance, generally set up by the lender as a convenience for the borrower and a protection against the possibility that a buyer might default on property taxes or neglect to have the property covered by fire insurance.

The impound account is considered a trust fund. California law requires impound accounts with banks and savings and loans, on loans secured by one– to four–family residences, to pay interest at the rate of at least 2% simple interest per annum.

Under California law (Civil Code Section 2954), no impound account can be required as a condition of a real estate loan on a single–family owner–occupied dwelling ***except***:

- Where required by state or federal regulatory authority
- Where the loan is insured or guaranteed by the state or federal government

- Upon failure of the owner to pay two consecutive tax installments prior to the delinquency dates
- On loans of 90% or more of the sale price or appraised value
- Whenever the combined principal amount of all loans secured by the property exceeds 80%.

Discount Points

An additional fee on certain loans is charged by a lender to offset the difference between the loan interest rate and the current discount rate (the percentage subtracted from a loan to increase the profit to a purchaser of the loan), to make the loan competitive in the secondary market. The greater the demand in the secondary money market, the higher the discount points will be. One discount point is roughly equivalent to adding 1/8% of prepaid interest to the nominal rate of 30 year period loan (based on a so–called "average" 8–year payoff of a loan). Discount points may also be paid to buy down interest rates or to buy down the terms of an adjustable rate mortgage.

Loan Broker Commission

For bringing together a lender and a borrower a broker may charge a fee, limited for some loans by Article 7 of the Real Estate law.

Imputed Interest

The minimum interest rate on seller financing up to $2.8 million is now 9%, compounded semi–annually. If a seller takes less than 9%, the IRS will impute the 9% rate and the seller will pay income tax on that amount of interest. The reason for imputed interest is to prevent sellers from unlawfully converting ordinary income into capital gain.

For seller financing over $2.8 million the minimum interest rate is the "Applicable Federal Rate" (AFR), an index published by the U.S. Treasury Department. The AFR is based on the recent interest yields on marketable U.S. government securities such as Treasury bills and Treasury notes. An AFR table is released each month and applies to the following three months. The seller may use the lowest of the most recent three AFRs.

SECONDARY MORTGAGE MARKET

Loans made by mortgage bankers are customarily resold to other lenders and investors in the resale market known as the secondary market.

The purpose of the secondary market is to shift funds from capital surplus areas to capital short areas. One method involves lenders selling loans to each other. Lenders also sell participating interests in blocks of loans to other lenders. Mortgage–backed securities are another tool used to obtain money from the capital market. There are securities backed by FHA and DVA loans and others backed by conventional loans.

When lenders speak about the secondary mortgage market, they are not referring to second mortgages or deeds of trust. They are talking about a market where existing loans are bought and sold.

PRIMARY AND SECONDARY MORTGAGE MARKET

When a lender makes a loan directly to a borrower, that action takes place in the ***primary mortgage market.*** Later, that loan may be sold to a bank, pension fund, or some other investor. The sale of that loan takes place in the secondary market. For example, if a savings bank makes a loan directly to a borrower, it is involved in the primary market. If the loan is subsequently sold to the Federal Home loan Mortgage Corporation, that sale takes place in the secondary market.

The ***secondary mortgage market*** consists of private and Institutional lenders, investors, and government agencies that buy and sell mortgages to each other. In the secondary market, discounts are used constantly. Buyers and sellers of mortgages negotiate on the basis of yield. Discounts are used to adjust yields so agreements can be reached and sales made.

☞***Mortgage loan bankers are engaged in the primary mortgage market when making the loan and in the secondary mortgage market in the sale of the loan.***

☞ ***In secondary market:***
The purchasing and selling of* existing *mortgages and deeds of trust Lenders selling loans to other lenders and investors.

PURPOSE OF THE SECONDARY MARKET

The main purpose of the secondary market is to shift money from areas where there is a surplus to areas where there is a shortage.

In the early 1970s, depository institutions sold only a small portion of the loans they originated. They were able to rely on their savings inflow to finance the loans they made. During this time, interest rates and the flow of deposits were relatively stable. As the 1970s progressed, the institutions were forced to sell more loans in the secondary market because loan volume had increased greatly. A slow rate of new deposits, typically referred to as "rate of savings inflow," was not sufficient to take care of the higher demand for loans.

In the 1980s, institutions found their cost of acquiring deposits increasing dramatically. They also experienced a major outflow of deposits due to higher rates offered by competing investments, such as mutual funds and certain bonds. With less money to support the demand for loans, the institutions have increasingly turned to the secondary market for funds.

One industry that has always operated in the secondary mortgage market is mortgage banking. Mortgage bankers do not have deposits to lend; therefore, they have to sell the loans they make to other investors. They operate as a conduit between the primary market and the secondary market. In the 1990s, almost all mortgage lenders operated in the secondary market to maintain liquidity and to stabilize the supply and demand for mortgage money.

ADDITIONAL SOURCES FOR THE SECONDARY MARKET

On a nationwide basis, deposits in institutions are not sufficient to meet the demand for mortgages. Therefore, to obtain additional funds for mortgages, lenders have had to revert to the capital market. The capital market is the market for long–term investments, which include government and corporate bonds as well as mortgage loans. Some of the investors in the capital market buying long–term investments are insurance companies, trusts, pension funds, and individuals.

How Are Mortgage Funds Shifted?

There are a number of methods used in the marketplace to shift funds to where they are needed. One method is lenders selling loans to each other. For example, a savings bank in California may have more demand for loans than it can meet. A savings bank in Florida may have the opposite problem. The solution is to have the California savings bank sell loans to the Florida savings bank. The California savings bank would obtain additional funds to use to make new loans, and the Florida savings bank would be investing surplus funds.

Another method to move funds from one source to another is called *participation.* Participation occurs when one institution sells a part interest in a block of loans to another institution. For example, assume the California savings bank wanted to sell $10,000,000 in loans to the Florida savings bank. Rather than sell the entire block of loans, it could sell a 90% interest, or $9,000,000. The other 10% share, $1,000,000, would be retained by the lender. The California bank would continue to service the loans and pass on 90% of the mortgage payments to the Florida bank. FNMA and FHLMC are also actively involved with participation's in 5% increments, purchasing 90 or 95% of a loan. This enables the loan seller to leverage its funds. However, FNMA and FHLMC are more often involved in the sale of "whole" loans.

Mortgage–Backed Securities

Today the most common method used to move funds is by the use of mortgage–backed securities, which are backed by a pool of mortgages. They were created to make investing in mortgages as simple as buying stocks or bonds. Before then, lending institutions sold and purchased loans among themselves. This was not an efficient method–it was time consuming and involved a lot of paperwork. In addition, each lender had its own property and borrower standards, which further complicated transactions. More importantly, there was no system to obtain money from the capital markets. Lenders had to depend on deposits, which had proven to be volatile. The invention of the mortgage–backed security revolutionized the operation of the secondary market.

Collateralized Mortgage Obligations

Fannie Mae issues mortgage–backed securities called *collateralized mortgage* ***obligations*** (CMO). They were designed to limit prepayment risk to investors. Prior to this time, mortgage–backed securities were "passthroughs", which means that all the principal and interest collected were passed on to the investor. The investor had no protection from the early prepayment of principal.

When investors calculate yield, they make assumptions regarding the repayment of principal. When mortgages are paid early, the yield will change. Therefore investors are looking for a security that can provide some protection against early prepayment.

A CMO is divided into classes. For example, the first CMO had three classes. Each class paid interest on the outstanding balance. However, all collections of principal from the pool were first applied to class one. After that class had been paid in full, all principal collections went to class two. After class two had been paid in full, the remaining principal payments went to class three. The CMO gives investors opportunities to choose classes that offer different rates and maturities. The creation of the CMO attracted investors that were not normally mortgage investors.

Standardization of Forms

One major benefit brought about by the creation of mortgage–backed securities by Freddie Mac and Fannie Mae is the standardization of conventional loan forms and property and borrower standards. FHA and DVA loans have been readily sold in the secondary market for years. One of the reasons is that their forms are standardized. As an investor you could buy an FHA or DVA loan anywhere in the United States and know the exact loan provisions. Previously this could not be done with a conventional loan.

To have a functional secondary market for conventional loans, you must also have standardization. Freddie Mac and Fannie Mae have accomplished this by using the same forms and by having basically the same property and borrower standards. Almost all lenders today use the standard forms, and many adhere to the property and borrower standards set forth by the agencies. This gives the lenders great flexibility in ensuring that their loans can be sold in the secondary market.

Mortgage Revenue Bonds

The State of California and local governments have the authority to issue bonds. Interest paid on the bonds is tax exempt to the investors. Bonds sold by state and local governments are used to finance mortgages are called ***mortgage revenue bonds.*** Because the bonds are tax exempt, the interest rate is less than on a standard bond, and as a result, mortgage loans can be made at rates that are below market rate. The government agencies do not guarantee the bonds. The bonds are backed by the mortgages created by the bond funds. The issuer of the bond merely acts as a conduit; local lenders process, close, and then service the loans for the government. These bond issues generally work the same way as other mortgage–backed securities, but the paperwork is much more complex.

CHAPTER QUIZ

1. A loan which is paid in full by equal periodic payments over the loan term is called:

   A. Amortized
   B. Straight
   C Balloon payment
   D. Negative

2. The entire principal is due in a lump sum at the end of the term of a(n):

   A Amortized loan
   B Straight note
   C Interest–only loan
   D. Both B and C

3. A loan with a balloon payment is most likely to be:

   A Fully amortized
   B Partially amortized
   C. Straight
   D. Both (A) and B

4. The nominal rate of interest is:

   A Stated in a promissory note to the lender
   B 10% in California because the rate is set by law
   C Interest that is compounded daily
   D Also known as the legal rate as set by California law

5. All of the following participate in a national secondary market for real estate mortgages, ***except***
   A. FDIC
   B. FHLMC.
   C. GNMA.
   D. FNMA.

6. The formula for interest calculations is:

   A I = P x R x T
   B. R = I / P X T
   C T = I / P X R
   D. All of the above

7. The objectives and mechanics of the secondary mortgage market are many and varied, including

   A. Making below–market interest rate loans to home buyers.
   B. Buying and selling existing mortgages.
   C. Providing funds for needy sellers.
   D. Insuring loans for home buyers.

8. Which of the following is a major buyer and seller in the secondary mortgage market?

   A. FHA
   B. FNMA
   C. DVA
   D. Cal–Vet

9. In general, most monthly real estate loan payments are received by lenders:

   A On the 1st of the month
   B Between the 1st and 10th of the month
   C Between the 20th and 30th of the month
   D. On the 30th of the month

10. Which of the following is also significantly involved in the secondary mortgage market?

   A. Federal Reserve Board
   B. Federal Housing Administration

C. California Housing Finance Agency
D. Federal Home Loan Mortgage Corporation

Answer Key: 1–B, 2–D, 3–B, 4–A, 5–A, 6–A, 7–B, 8–B, 9–B, 10–D

CHAPTER 8: FINANCING INSTRUMENTS

PREVIEW

Just like any other professionals, real estate lenders use a variety of financing instruments to complete a real estate loan. In California, the major instruments of real estate finance are the promissory note, the deed of trust, and, to a lesser extent, the installment sales contract. In this chapter we will talk about these mortgage instruments, the meaning of voluntary money encumbrances (liens) their effects of security, and the various loan clauses that are used in the mortgage instruments.

FINANCING INSTRUMENTS

Real estate loans in California generally are made using two instruments, ***promissory notes*** and ***security instruments*** (trust deed, mortgage or land contract). A promissory note is evidence of the underlying obligation of the loan transaction. Security instruments (trust deed or mortgage) are financing instruments used to identify the real estate that serves as assurance that the loan will be repaid. Usually, borrowers hypothecate their real property as security for payment of the promissory note.

PROMISSORY NOTE

When money is borrowed to purchase real estate, the borrower agrees to repay the loan by signing a *promissory note,* which outlines the terms of repayment and sets the due date. The promissory note is legal evidence that a debt is owed. The two most common types of promissory notes in general use are the ***straight note*** and the ***installment note***.

☞ ***The straight note is an interest–only note.***

Under a straight note, the borrower agrees to pay the interest periodically (or all at one time, when the note matures) and to pay the entire principal in a lump sum on the due date.

The second type of real estate promissory note, and by far the most common, is the *installment note.* An installment note requires periodic payments that include both ***principal and interest***. This reduction in principal is referred to as ***amortization****.*

Amortization notes will be discussed in details in later chapter.

CHARACTERISTICS OF PROMISSORY NOTE

Whether a debt is secured by real property, personal property, or has no security at all, the promissory note is the legal, enforceable promise to pay back the money borrowed. It is the ***"evidence of the debt."***

- Promissory notes are called *"two party paper."* The *maker* of a note promises to pay the *holder* of the note a specified sum of money according to the terms stated on the note.
- **Payor** – The maker of the note; the one who pays; the borrower.
- **Payee** – The holder of the note; the receiver of the money payable under the note; the lender.

NEGOTIABLE NOTES

These are notes freely transferable in commerce. When properly prepared, they are typically accepted as the equivalent of cash. To be considered a negotiable note, the instrument must conform to statutory requirements. It must be:

- An unconditional promise to pay
- In writing

- Made by one person to another Signed by the maker
- Payable upon demand or on a fixed date
- For a specific sum of money
- Payable either "to the order of" or "to the bearer"

All of these elements must be present if the instrument is to qualify as a negotiable note.

ENDORSEMENT OF NOTES

If a note is payable "to bearer," endorsement is not necessary since the note is transferred by simple delivery to the other person. Paper money is such a note. If the note is payable to a named person, that person must "order" the maker to pay to the transferee by an endorsement. The endorsement may be:

- **In Blank** – Endorsement with a signature alone makes the note payable to any bearer of the note.
- **Special** – Holder endorses "pay to the order of (name of new payee)" and signs the note; the note is now payable only to the new payee.
- **Restrictive** – Holder restricts further negotiability by writing "for deposit only" and signs the note.
- **Qualified** – Adding the words "without recourse" before signing a note means the endorser will not be liable for the amount of the note if the maker refuses to pay.

HOLDER IN DUE COURSE

One who takes a negotiable note which has been transferred from the original payee through endorsement becomes a holder in due course, with certain rights, under the following conditions:

- **Valid Note** – Note is valid on its face.
- **Innocent of Defects** – Holder became the holder of the note without knowledge of any defects (if such exist).

- **Good Faith and Consideration** – Holder took the note in good faith and for a valuable consideration.

DEFENSES BY THE MAKER

Under certain circumstances the maker of the note cannot be held to the promise to pay. Some circumstances affect the debt only as against the original payee; some affect any subsequent holder.

- **Personal Defenses** – The maker may use the following commonly recognized personal defenses against the original payee, but *not* against a holder in due course.
  - Fraud in inducement, e.g., false statements used by the payee to procure the signing of the note.
  - Lack of valuable consideration from the payee to the maker.
  - Prior payment or cancellation.
  - If payee owed maker an amount of money on another obligation, the current negotiable note is not a "set–off' once it has been transferred to a holder in due course.
- **Real Defenses** – These are defenses allowed against anyone, even a holder in due course; they result from major defects in the validity of the contract or document
  - Incapacity of the maker.
  - Illegality of the instrument, such as a note used in connection with illegal conduct
  - Forged document.
  - Material alteration (holder in due course may collect on original legal terms of the note).

Form 8-1: Promissory Note (3 pages)

NOTE

___________________________, _________ ___________________________, _______________
[Date] [City] [State]

____
[Property Address]

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $____________________ (this amount is called "Principal"), plus interest, to the order of the Lender. The Lender is ____. I will make all payments under this Note in the form of cash, check or money order.

I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder."

2. INTEREST

Interest will be charged on unpaid principal until the full amount of Principal has been paid. I will pay interest at a yearly rate of ________________%.

The interest rate required by this Section 2 is the rate I will pay both before and after any default described in Section 6(B) of this Note.

3. PAYMENTS

(A) Time and Place of Payments

I will pay principal and interest by making a payment every month.

I will make my monthly payment on the __________ day of each month beginning on ____________________, ______. I will make these payments every month until I have paid all of the principal and interest and any other charges described below that I may owe under this Note. Each monthly payment will be applied as of its scheduled due date and will be applied to interest before Principal. If, on ___________________________________, 20____, I still owe amounts under this Note, I will pay those amounts in full on that date, which is called the "Maturity Date."

I will make my monthly payments at ____ or at a different place if required by the Note Holder.

(B) Amount of Monthly Payments

My monthly payment will be in the amount of U.S. $____________________________________.

4. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a "Prepayment." When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate a payment as a Prepayment if I have not made all the monthly payments due under the Note.

I may make a full Prepayment or partial Prepayments without paying a Prepayment charge. The Note Holder will use my Prepayments to reduce the amount of Principal that I owe under this Note. However, the Note Holder may apply my Prepayment to the accrued and unpaid interest on the Prepayment amount, before applying my Prepayment to reduce the Principal amount of the Note. If I make a partial Prepayment, there will be no changes in the due date or in the amount of my monthly payment unless the Note Holder agrees in writing to those changes.

5. LOAN CHARGES

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the Principal I owe under this Note or by making a direct payment to me. If a refund reduces Principal, the reduction will be treated as a partial Prepayment.

6. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charge for Overdue Payments

If the Note Holder has not received the full amount of any monthly payment by the end of ___________ calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be _____% of my overdue payment of principal and interest. I will pay this late charge promptly but only once on each late payment.

(B) Default

If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.

(C) Notice of Default

If I am in default, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date, the Note Holder may require me to pay immediately the full amount of Principal which has not been paid and all the interest that I owe on that amount. That date must be at least 30 days after the date on which the notice is mailed to me or delivered by other means.

(D) No Waiver By Note Holder

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(E) Payment of Note Holder's Costs and Expenses

If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees.

7. GIVING OF NOTICES

Unless applicable law requires a different method, any notice that must be given to me under this Note will be given by delivering it or by mailing it by first class mail to me at the Property Address above or at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by delivering it or by mailing it by first class mail to the Note Holder at the address stated in Section 3(A) above or at a different address if I am given a notice of that different address.

8. OBLIGATIONS OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each person is fully and personally obligated to keep all of the promises made in this Note, including the promise to pay the full amount owed. Any person who is a guarantor, surety or endorser of this Note is also obligated to do these things. Any person who takes over these obligations, including the obligations of a guarantor, surety or endorser of this Note, is also obligated to keep all of the promises made in this Note. The Note Holder may enforce its rights under this Note against each person individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note.

9. WAIVERS

I and any other person who has obligations under this Note waive the rights of Presentment and Notice of Dishonor. "Presentment" means the right to require the Note Holder to demand payment of amounts due. "Notice of Dishonor" means the right to require the Note Holder to give notice to other persons that amounts due have not been paid.

10. UNIFORM SECURED NOTE

This Note is a uniform instrument with limited variations in some jurisdictions. In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust, or Security Deed (the "Security Instrument"), dated the same date as this Note, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note. That Security Instrument describes how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note. Some of those conditions are described as follows:

> If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.

If Lender exercises this option, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

WITNESS THE HAND(S) AND SEAL(S) OF THE UNDERSIGNED

________________________________ (Seal)
- Borrower

________________________________ (Seal)
- Borrower

________________________________ (Seal)
- Borrower

[Sign Original Only]

MULTISTATE FIXED RATE NOTE—Single Family—**Fannie Mae/Freddie Mac UNIFORM INSTRUMENT** Form 3200 1/01 *(page 3 of 3 pages)*

MORTGAGES AND TRUST DEEDS

Mortgages and trust deeds are liens, or charges upon a property, by which property or title has been made the security for repayment of money by the borrower. The term "mortgage" is commonly used with two different meanings. In its generic meaning, the word mortgage is used to describe any device used for the pledging of property to a creditor as security for the payment of a debt. In that sense of the word, it is correct to say that in California we usually use the deed of trust as our form of mortgage. In California we have "mortgage companies," not "trust deed companies." On the other hand, a standard mortgage contract is technically quite different from a trust deed and is *rarely used in California*, although it is still used in a majority of the states.

We will look at mortgages and trust deeds as distinctly different instruments, although both have the same purpose as security devices.

HYPOTHECATION

To **hypothecate** is to give title of a property as security for a loan without the necessity of giving up possession or use of the property. ***This principle is fundamental to the major instruments of real estate finance, i.e., the trust deed in California and the less common mortgage***. Each of these instruments uses the promissory note as the primary evidence of debt, which creates a lien on the property.

MORTGAGE CONTRACT

A mortgage is a written contract by which title to property is hypothecated (promised without giving up possession) to secure repayment of money borrowed. The borrower retains both title and possession.

CHARACTERISTICS OF MORTGAGE CONTRACT:

- **Parties** – A mortgage contract has two parties, the mortgagor and the mortgagee.
  - **Mortgagor** – Owner or buyer (borrower), who gives a mortgage as security to the mortgagee.

- **Mortgagee** – Lender or seller, who receives a mortgage from the mortgagor as security for repayment of a loan.

- **Recording** – Recording establishes priority by giving constructive notice "to the world" of the contents of a document For a mortgage to be recordable, it must be acknowledged by the mortgagor (usually in the presence of a notary public who receives the acknowledgment).

- **Release** – Upon payment in full, the mortgagor is given a "satisfaction of mortgage." Upon recording, this releases the title from the lien. A new law effective July 1, 1989, requires that within 30 days after any mortgage has been satisfied, the mortgagee must execute and record a certificate of discharge, and must then, if requested, deliver to the mortgagor the original note and mortgage. (You will note later some different requirements if the obligation was secured by a deed of trust.)

FORECLOSURE

By Superior Court action, a mortgagee may foreclose within four years of delinquency or maturity of the mortgage contract. Foreclosure is by "judicial sale." The steps involved are:

- Complaint is filed.
- Trial is held.
- Court issues a decree of foreclosure and an order of sale.
- Sheriff or court commissioner auctions property after legal notice has been posted and published.
- Property is sold to the highest bidder at sale.
- Buyer at sale is issued a ***"certificate of sale,"*** but does not receive immediate title or possession.
    - If a deficiency judgment is possible, the property is sold subject to the "right of redemption." The mortgagor may have a ***three–month right of redemption*** (or "***equity rights of redemption***") if the sale proceeds are sufficient to pay the secured indebtedness plus interest and costs of foreclosure, or a ***one year right of redemption*** (or "***statutory rights of redemption)*** if the sale

proceeds are not sufficient to satisfy the secured indebtedness with interest and costs of action and of sale.

- Mortgagor may remain in possession during "redemption period," which could be up to one year.

- At the end of the redemption period, a "sheriff's deed" is issued to the new owner of title.

Power of Sale Clause

This clause in a mortgage makes foreclosure out of court possible, using the same procedures as a trustee's sale under a trust deed (non–judicial sale). Power of sale clause will be discussed in detail in this chapter under Loan Clauses.

Deficiency Judgment

If the sale proceeds do not fully satisfy the debts secured by the mortgage, a deficiency judgment may be granted by the court against the debtor.

However, deficiency judgments are prohibited on a:

- Mortgage given to seller for all or part of the purchase price.
- Mortgage given to a lender to finance purchase of an owner–occupied dwelling of 4 units or less.

TRUST DEED

In real estate financing in California and some other states, a deed of trust is generally used along with a promissory note (evidence of debt) as a security device; it creates a lien on the property when recorded. A trust deed is a security device which is both a contract and a conveyance, pledging property as a guarantee for repayment of a debt. **"Bare legal title"** is conveyed by a trustor to a trustee for the lender's benefit. In case of default, the trustee has the power to foreclose out of court at the request of the beneficiary.

CHARACTERISTICS OF TRUST DEED

- **Parties** – In addition to the borrower and lender, the trust deed involves a third party, the trustee.
  - **Trustor** – The borrower. The owner or buyer who deeds bare legal title of property securing the loan to a trustee to be held as security until the trustor has performed the obligation to the lender under the terms of the deed of trust
  - **Beneficiary** – The lender. The holder of the promissory note and of the trust deed guaranteeing repayment. Benefits from the "trust"
  - **Trustee** – A neutral third party. Holder, in trust, of the "bare legal title" with the power of sale described above.
- **Effect of Title** – **Bare (or naked) Legal Title** is transferred by the trust deed to a trustee (intermediary between trustor and beneficiary) who has "power of sale" in the event of default by the trustor. Equitable title remains with the trustor, who can also give a junior trust deed (or deeds).
- **Recordation** – Recording of the trust deed is permitted and recommended; it establishes priority. Recording is not required to make a trust deed effective.
  - **Short Form** – So that only the front page of a trust deed need be recorded, most trust deeds are written as a "Short Form Deed of Trust and Assignment of Rents," which makes reference to information contained on the reverse side which has been previously recorded in the same county.
  - **Fictitious Deed of Trust** – This is a device used to put all standard provisions of any given lender or title company, etc., on the public record *in any county* in which the *firm does business*. It is "fictitious" in the sense that it does not cite a specific property.

    Only the front side of subsequent "actual" trust deeds need be recorded, showing names, property data, and other variables. The borrower agrees to all of the terms printed on the back of the trust deed, terms recorded in the earlier fictitious deed of trust. This procedure saves in fees, records space, and unnecessary duplication.

The reverse side of the actual trust deed contains a reprint of the standard provisions, for easy reference by the trustor or others.

- **Priority** – The earliest recording date makes it a first trust deed, unless it contains a ***subordination clause***, by which the beneficiary agrees to move to a junior position if another trust deed (usually a construction loan) is recorded at a later date.

RELATION OF TRUST DEED TO NOTE

The lien of a trust deed or mortgage used as a security device to assure the payment of debt, by using title to real property as security, is a mere incident of the debt. Without the debt, there is no lien.

- **Validity** – if the note is unenforceable, the mortgage or trust deed gives it no validity.
- **Obligation** – The note and the mortgage or trust deed are to be construed together; therefore, a clause in either obligates the other.
- **Conflict in Terms** – If any conflict exists between the provisions of the note and the mortgage or trust deed, the note will take priority.
- **Assignment** – In case of assignment, the note and the security device (mortgage or trust deed) must go together. They cannot be assigned independently.
- **Release** –The lien is released by reconveyance of the title from the trustee to the trustor by recording of a deed of reconveyance.
- **Request for Reconveyance** – When the obligation secured by any deed of trust has been satisfied, the beneficiary must deliver to the trustee the original note, the deed of trust, and a request for full reconveyance.

DEED OF RECONVEYANCE

The trustee must record a deed of reconveyance within 21 calendar days after receipt of the request for reconveyance and appropriate fees.

- **60 Day limit** – If the trustee has failed to record the reconveyance within 60 calendar days of the satisfaction of the obligation, the beneficiary, upon written request by the trustor, shall substitute itself or another trustee and issue a full reconveyance.

- **75 Day limit** – If a full reconveyance has not been recorded within 75 calendar days of satisfaction, then a title insurance company may prepare and record a release of the obligation, which release will be equivalent to a reconveyance of title.

- **Violations** – Any violator of these requirements shall be liable for actual damages plus $300. In addition, any person who willfully violates this law is guilty of a misdemeanor, punishable by a fine up to $400 and/or imprisonment in the county jail for up to six months.

Foreclosure by Trustee's Sale

One reason for the popularity of trust deeds with lenders is the availability of a non–judicial foreclosure procedure.

Notice of Default

The beneficiary notifies the trustee of default, then notifies the trustor and records the "notice of default." The trustee is also obligated to provide notices to all other lienholders of record and to anyone who has recorded a request for notice of default.

Redemption Period

The trustee must wait a minimum of three months, during which the trustor may avoid sale in various ways.

- The trustor may reinstate the loan by making delinquent payments and penalties up to within 5 days of the sale.

- The trustor may give a "deed in lieu of foreclosure" to satisfy the lien, if the lienholder is willing. The lienholder takes title subject to all other existing liens. This procedure protects the borrower's credit and avoids foreclosure costs.

- The trustor may pay the entire balance.

NOTICE OF SALE

The trustee publishes a **"notice of sale"** once a week for 20 days and posts notice on property. In addition, the notice of sale must be recorded in the county where the property is located at least 14 days prior to the sale. Sale date is usually 22 or 23 days after notice.

- The notice must include a description of the property or, if none is available, the name and address of the beneficiary.
- The trustor may still pay off the full loan and penalties prior to the sale; no redemption right exists after the sale.

TRUSTEE'S AUCTION

The trustee sells to the highest bidder, pays expenses and lien(s), and issues a trustee's deed.

- Title is cleared of all junior liens except possible mechanics liens or real estate tax liens.
- No deficiency judgment is allowed following a trustee's sale. However, a foreclosing beneficiary at a trustee's sale may later sue for damages and pursue postsale claims against the trustor for bad faith waste and fraud. To do so the beneficiary must have made a credit bid at the trustee's auction that was less than the amount of the secured debt and foreclosure costs.

FORECLOSURE TIME

The foreclosure process under a trust deed is relatively speedy compared to the court proceedings under a mortgage.

- **"Notice of default"** – 3 months minimum plus additional time which may be granted.
- "Notice of sale" –20 days.

- Total time to accomplish foreclosure – approximately 4 months.

TRUSTOR'S RIGHT OF REINSTATEMENT

A debt under a trust deed can be reinstated by a trustor if payment of the overdue amount is made at any time after the notice of default is recorded, but no later than ***five (5) business days*** prior to the date of sale in the subsequent recorded **notice of sale.**

Reinstatement within the five-day period preceding the sale would be at the discretion of the beneficiary and might still be allowed.

Figure 8-1 Trustee's Sale Timetable

TRUSTEE'S SALE TIMETABLE

10-15 DAYS	3 MONTHS	21 DAYS	1 DAY
Notice of Default	Reinstatement Period (Waiting Period)	Notice of Sale Publishing	Trustee's Sale

FORECLOSURE BY COURT (JUDICIAL)

The method of foreclosing on a trust deed is the choice of the beneficiary. Court action could be chosen to gain the opportunity for a deficiency judgment.

Procedure – The procedure becomes the same as for a mortgage.

Form 8-1: Deed of Trust (16 pages)

After Recording Return To:

____

____

____

____

____________________**[Space Above This Line For Recording Data]**____________________

DEED OF TRUST

DEFINITIONS

Words used in multiple sections of this document are defined below and other words are defined in Sections 3, 11, 13, 18, 20 and 21. Certain rules regarding the usage of words used in this document are also provided in Section 16.

(A) **"Security Instrument"** means this document, which is dated ______________________, ______, together with all Riders to this document.
(B) **"Borrower"** is ____. Borrower is the trustor under this Security Instrument.
(C) **"Lender"** is ____. Lender is a ____ organized and existing under the laws of _____________________________________. Lender's address is __________________________ ________________________________. Lender is the beneficiary under this Security Instrument.
(D) **"Trustee"** is ____.
(E) **"Note"** means the promissory note signed by Borrower and dated __________________, ______. The Note states that Borrower owes Lender ____________________________________ ___________________ Dollars (U.S. $______________________________________) plus interest. Borrower has promised to pay this debt in regular Periodic Payments and to pay the debt in full not later than _______________________________.
(F) **"Property"** means the property that is described below under the heading "Transfer of Rights in the Property."
(G) **"Loan"** means the debt evidenced by the Note, plus interest, any prepayment charges and late charges due under the Note, and all sums due under this Security Instrument, plus interest.
(H) **"Riders"** means all Riders to this Security Instrument that are executed by Borrower. The following Riders are to be executed by Borrower [check box as applicable]:

- ☐ Adjustable Rate Rider
- ☐ Balloon Rider
- ☐ 1-4 Family Rider
- ☐ Condominium Rider
- ☐ Planned Unit Development Rider
- ☐ Biweekly Payment Rider
- ☐ Second Home Rider
- ☐ Other(s) [specify] _________

(I) **"Applicable Law"** means all controlling applicable federal, state and local statutes, regulations, ordinances and administrative rules and orders (that have the effect of law) as well as all applicable final, non-appealable judicial opinions.

(J) **"Community Association Dues, Fees, and Assessments"** means all dues, fees, assessments and other charges that are imposed on Borrower or the Property by a condominium association, homeowners association or similar organization.

(K) **"Electronic Funds Transfer"** means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, computer, or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, transfers initiated by telephone, wire transfers, and automated clearinghouse transfers.

(L) **"Escrow Items"** means those items that are described in Section 3.

(M) **"Miscellaneous Proceeds"** means any compensation, settlement, award of damages, or proceeds paid by any third party (other than insurance proceeds paid under the coverages described in Section 5) for: (i) damage to, or destruction of, the Property; (ii) condemnation or other taking of all or any part of the Property; (iii) conveyance in lieu of condemnation; or (iv) misrepresentations of, or omissions as to, the value and/or condition of the Property.

(N) **"Mortgage Insurance"** means insurance protecting Lender against the nonpayment of, or default on, the Loan.

(O) **"Periodic Payment"** means the regularly scheduled amount due for (i) principal and interest under the Note, plus (ii) any amounts under Section 3 of this Security Instrument.

(P) **"RESPA"** means the Real Estate Settlement Procedures Act (12 U.S.C. §2601 et seq.) and its implementing regulation, Regulation X (24 C.F.R. Part 3500), as they might be amended from time to time, or any additional or successor legislation or regulation that governs the same subject matter. As used in this Security Instrument, "RESPA" refers to all requirements and restrictions that are imposed in regard to a "federally related mortgage loan" even if the Loan does not qualify as a "federally related mortgage loan" under RESPA.

(Q) **"Successor in Interest of Borrower"** means any party that has taken title to the Property, whether or not that party has assumed Borrower's obligations under the Note and/or this Security Instrument.

TRANSFER OF RIGHTS IN THE PROPERTY

This Security Instrument secures to Lender: (i) the repayment of the Loan, and all renewals, extensions and modifications of the Note; and (ii) the performance of Borrower's covenants and agreements under this Security Instrument and the Note. For this purpose, Borrower irrevocably grants and conveys to Trustee, in trust, with power of sale, the following described property located in the ______________________________ of ______________________________:

[Type of Recording Jurisdiction] [Name of Recording Jurisdiction]

CALIFORNIA–Single Family–**Fannie Mae/Freddie Mac UNIFORM INSTRUMENT** **Form 3005** **1/01** *(page 2 of 16 pages)*

which currently has the address of ____
[Street]
______________________, California ______________ ("Property Address"):
[City] [Zip Code]

TOGETHER WITH all the improvements now or hereafter erected on the property, and all easements, appurtenances, and fixtures now or hereafter a part of the property. All replacements and additions shall also be covered by this Security Instrument. All of the foregoing is referred to in this Security Instrument as the "Property."

BORROWER COVENANTS that Borrower is lawfully seised of the estate hereby conveyed and has the right to grant and convey the Property and that the Property is unencumbered, except for encumbrances of record. Borrower warrants and will defend generally the title to the Property against all claims and demands, subject to any encumbrances of record.

THIS SECURITY INSTRUMENT combines uniform covenants for national use and non-uniform covenants with limited variations by jurisdiction to constitute a uniform security instrument covering real property.

UNIFORM COVENANTS. Borrower and Lender covenant and agree as follows:

1. **Payment of Principal, Interest, Escrow Items, Prepayment Charges, and Late Charges.** Borrower shall pay when due the principal of, and interest on, the debt evidenced by the Note and any prepayment charges and late charges due under the Note. Borrower shall also pay funds for Escrow Items pursuant to Section 3. Payments due under the Note and this Security Instrument shall be made in U.S. currency. However, if any check or other instrument received by Lender as payment under the Note or this Security Instrument is returned to Lender unpaid, Lender may require that any or all subsequent payments due under the Note and this Security Instrument be made in one or more of the following forms, as selected by Lender: (a) cash; (b) money order; (c) certified check, bank check, treasurer's check or cashier's check, provided any such check is drawn upon an institution whose deposits are insured by a federal agency, instrumentality, or entity; or (d) Electronic Funds Transfer.

Payments are deemed received by Lender when received at the location designated in the Note or at such other location as may be designated by Lender in accordance with the notice provisions in Section 15. Lender may return any payment or partial payment if the payment or partial payments are insufficient to bring the Loan current. Lender may accept any payment or partial payment insufficient to bring the Loan current, without waiver of any rights hereunder or prejudice to its rights to refuse such payment or partial payments in the future, but Lender is not obligated to apply such payments at the time such payments are accepted. If each Periodic Payment is applied as of its scheduled due date, then Lender need not pay interest on unapplied funds. Lender may hold such unapplied funds until Borrower makes payment to bring the Loan current. If Borrower does not do so within a reasonable period of time, Lender shall either apply such funds or return them to Borrower. If not applied earlier, such funds will be applied to the outstanding principal balance under the Note immediately prior to foreclosure. No offset or claim which Borrower might have now or in the future against Lender shall relieve Borrower from making payments due under the Note and this Security Instrument or performing the covenants and agreements secured by this Security Instrument.

2. **Application of Payments or Proceeds.** Except as otherwise described in this Section 2, all payments accepted and applied by Lender shall be applied in the following order of priority: (a) interest due under the Note; (b) principal due under the Note; (c) amounts due under Section 3. Such payments shall be applied to each Periodic Payment in the order in which it became due. Any remaining amounts shall be applied first to late charges, second to any other amounts due under this Security Instrument, and then to reduce the principal balance of the Note.

If Lender receives a payment from Borrower for a delinquent Periodic Payment which includes a sufficient amount to pay any late charge due, the payment may be applied to the delinquent payment and the late charge. If more than one Periodic Payment is outstanding, Lender may apply any payment received from Borrower to the repayment of the Periodic Payments if, and to the extent that, each payment can be paid in full. To the extent that any excess exists after the payment is applied to the full payment of one or more Periodic Payments, such excess may be applied to any late charges due. Voluntary prepayments shall be applied first to any prepayment charges and then as described in the Note.

Any application of payments, insurance proceeds, or Miscellaneous Proceeds to principal due under the Note shall not extend or postpone the due date, or change the amount, of the Periodic Payments.

3. **Funds for Escrow Items.** Borrower shall pay to Lender on the day Periodic Payments are due under the Note, until the Note is paid in full, a sum (the "Funds") to provide for payment of amounts due for: (a) taxes and assessments and other items which can attain priority over this Security Instrument as a lien or encumbrance on the Property; (b) leasehold payments or ground rents on the Property, if any; (c) premiums for any and all insurance required by Lender under Section 5; and (d) Mortgage Insurance premiums, if any, or any sums payable by Borrower to Lender in lieu of the payment of Mortgage Insurance premiums in accordance with the provisions of Section 10. These items are called "Escrow Items." At origination or at any time during the term of the Loan, Lender may require that Community Association Dues, Fees, and Assessments, if any, be escrowed by Borrower, and such dues, fees and assessments shall be an Escrow Item. Borrower shall promptly furnish to Lender all notices of amounts to be paid under this Section. Borrower shall pay Lender the Funds for Escrow Items unless Lender waives Borrower's obligation to pay the Funds for any or all Escrow Items. Lender may waive Borrower's obligation to pay to Lender Funds for any or all Escrow Items at any time. Any such waiver may only be in writing. In the event of such waiver, Borrower shall pay directly, when and where payable, the amounts due for any Escrow Items for which payment of Funds has been waived by Lender and, if Lender requires, shall furnish to Lender receipts evidencing such payment within such time period as Lender may require. Borrower's obligation to make such payments and to provide receipts shall for all purposes be deemed to be a covenant and agreement contained in this Security Instrument, as the phrase "covenant and agreement" is used in Section 9. If Borrower is obligated to pay Escrow Items directly, pursuant to a waiver, and Borrower fails to pay the amount due for an Escrow Item, Lender may exercise its rights under Section 9 and pay such amount and Borrower shall then be obligated under Section 9 to repay to Lender any such amount. Lender may revoke the waiver as to any or all Escrow Items at any time by a notice given in accordance with Section 15 and, upon such revocation, Borrower shall pay to Lender all Funds, and in such amounts, that are then required under this Section 3.

Lender may, at any time, collect and hold Funds in an amount (a) sufficient to permit Lender to apply the Funds at the time specified under RESPA, and (b) not to exceed the maximum amount a lender can require under RESPA. Lender shall estimate the amount of Funds due on the basis of current data and reasonable estimates of expenditures of future Escrow Items or otherwise in accordance with Applicable Law.

The Funds shall be held in an institution whose deposits are insured by a federal agency, instrumentality, or entity (including Lender, if Lender is an institution whose deposits are so insured) or in any Federal Home Loan Bank. Lender shall apply the Funds to pay the Escrow Items no later than the time specified under RESPA. Lender shall not charge Borrower for holding and applying the Funds, annually analyzing the escrow account, or verifying the Escrow Items, unless Lender pays Borrower interest on the Funds and Applicable Law permits Lender to make such a charge. Unless an agreement is made in writing or Applicable Law requires interest to be paid on the Funds, Lender shall not be required to pay Borrower any interest or earnings on the Funds. Borrower and Lender can agree in writing, however, that interest shall be paid on the Funds. Lender shall give to Borrower, without charge, an annual accounting of the Funds as required by RESPA.

If there is a surplus of Funds held in escrow, as defined under RESPA, Lender shall account to Borrower for the excess funds in accordance with RESPA. If there is a shortage of Funds held in escrow, as defined under RESPA, Lender shall notify Borrower as required by RESPA, and Borrower shall pay to Lender the amount necessary to make up the shortage in accordance with RESPA, but in no more than 12 monthly payments. If there is a deficiency of Funds held in escrow, as defined under RESPA, Lender shall notify Borrower as required by RESPA, and Borrower shall pay to Lender the amount necessary to make up the deficiency in accordance with RESPA, but in no more than 12 monthly payments.

Upon payment in full of all sums secured by this Security Instrument, Lender shall promptly refund to Borrower any Funds held by Lender.

4. Charges; Liens. Borrower shall pay all taxes, assessments, charges, fines, and impositions attributable to the Property which can attain priority over this Security Instrument, leasehold payments or ground rents on the Property, if any, and Community Association Dues, Fees, and Assessments, if any. To the extent that these items are Escrow Items, Borrower shall pay them in the manner provided in Section 3.

Borrower shall promptly discharge any lien which has priority over this Security Instrument unless Borrower: (a) agrees in writing to the payment of the obligation secured by the lien in a manner acceptable to Lender, but only so long as Borrower is performing such agreement; (b) contests the lien in good faith by, or defends against enforcement of the lien in, legal proceedings which in Lender's opinion operate to prevent the enforcement of the lien while those proceedings are pending, but only until such proceedings are concluded; or (c) secures from the holder of the lien an agreement satisfactory to Lender subordinating the lien to this Security Instrument. If Lender determines that any part of the Property is subject to a lien which can attain priority over this Security Instrument, Lender may give Borrower a notice identifying the lien. Within 10 days of the date on which that notice is given, Borrower shall satisfy the lien or take one or more of the actions set forth above in this Section 4.

Lender may require Borrower to pay a one-time charge for a real estate tax verification and/or reporting service used by Lender in connection with this Loan.

5. Property Insurance. Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term "extended coverage," and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance. This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires. What Lender requires pursuant to the preceding sentences can change during the term of the Loan. The insurance carrier providing the insurance shall be chosen by Borrower subject to Lender's right to disapprove Borrower's choice, which right shall not be exercised unreasonably. Lender may require Borrower to pay, in connection with this Loan, either: (a) a one-time charge for flood zone determination, certification and tracking services; or (b) a one-time charge for flood zone determination and certification services and subsequent charges each time remappings or similar changes occur which reasonably might affect such determination or certification. Borrower shall also be responsible for the payment of any fees imposed by the Federal Emergency Management Agency in connection with the review of any flood zone determination resulting from an objection by Borrower.

If Borrower fails to maintain any of the coverages described above, Lender may obtain insurance coverage, at Lender's option and Borrower's expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage shall cover Lender, but might or might not protect Borrower, Borrower's equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was previously in effect. Borrower acknowledges that the cost of the insurance coverage so obtained might significantly exceed the cost of insurance that Borrower could have obtained. Any amounts disbursed by Lender under this Section 5 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment.

All insurance policies required by Lender and renewals of such policies shall be subject to Lender's right to disapprove such policies, shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee and Borrower further agrees to generally assign rights to insurance proceeds to the holder of the Note up to the amount of the outstanding loan balance. Lender shall have the right to hold the policies and renewal certificates. If Lender requires, Borrower shall promptly give to Lender all receipts of paid premiums and renewal notices. If Borrower obtains any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy shall include a standard mortgage clause and shall name Lender as mortgagee and/or as an additional loss payee and Borrower further agrees to generally assign rights to insurance proceeds to the holder of the Note up to the amount of the outstanding loan balance.

In the event of loss, Borrower shall give prompt notice to the insurance carrier and Lender. Lender may make proof of loss if not made promptly by Borrower. Unless Lender and Borrower otherwise agree in writing, any insurance proceeds, whether or not the underlying insurance was required by Lender, shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened. During such repair and restoration period, Lender shall have the right to hold such insurance proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such insurance proceeds, Lender shall not be required to pay Borrower any interest or earnings on such proceeds. Fees for public adjusters, or other third parties, retained by Borrower shall not be paid out of the insurance proceeds and shall be the sole obligation of Borrower. If the restoration or repair is not economically feasible or Lender's security would be lessened, the insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such insurance proceeds shall be applied in the order provided for in Section 2.

If Borrower abandons the Property, Lender may file, negotiate and settle any available insurance claim and related matters. If Borrower does not respond within 30 days to a notice from Lender that the insurance carrier has offered to settle a claim, then Lender may negotiate and settle the claim. The 30-day period will begin when the notice is given. In either event, or if Lender acquires the Property under Section 22 or otherwise, Borrower hereby assigns to Lender (a) Borrower's rights to any insurance proceeds in an amount not to exceed the amounts unpaid under the Note or this Security Instrument, and (b) any other of Borrower's rights (other than the right to any refund of unearned premiums paid by Borrower) under all insurance policies covering the Property, insofar as such rights are applicable to the coverage of the Property. Lender may use the insurance proceeds either to repair or restore the Property or to pay amounts unpaid under the Note or this Security Instrument, whether or not then due.

6. Occupancy. Borrower shall occupy, establish, and use the Property as Borrower's principal residence within 60 days after the execution of this Security Instrument and shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender otherwise agrees in writing, which consent shall not be unreasonably withheld, or unless extenuating circumstances exist which are beyond Borrower's control.

7. Preservation, Maintenance and Protection of the Property; Inspections. Borrower shall not destroy, damage or impair the Property, allow the Property to deteriorate or commit waste on the Property. Whether or not Borrower is residing in the Property, Borrower shall maintain the Property in order to prevent the Property from deteriorating or decreasing in value due to its condition. Unless it is determined pursuant to Section 5 that repair or restoration is not economically feasible, Borrower shall promptly repair the Property if damaged to avoid further deterioration or damage. If insurance or condemnation proceeds are paid in connection with damage to, or the taking of, the Property, Borrower shall be responsible for repairing or restoring the Property only if Lender has released proceeds for such purposes. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed. If the insurance or condemnation proceeds are not sufficient to repair or restore the Property, Borrower is not relieved of Borrower's obligation for the completion of such repair or restoration.

Lender or its agent may make reasonable entries upon and inspections of the Property. If it has reasonable cause, Lender may inspect the interior of the improvements on the Property. Lender shall give Borrower notice at the time of or prior to such an interior inspection specifying such reasonable cause.

8. Borrower's Loan Application. Borrower shall be in default if, during the Loan application process, Borrower or any persons or entities acting at the direction of Borrower or with Borrower's knowledge or consent gave materially false, misleading, or inaccurate information or statements to Lender (or failed to provide Lender with material information) in connection with the Loan. Material representations include, but are not limited to, representations concerning Borrower's occupancy of the Property as Borrower's principal residence.

9. Protection of Lender's Interest in the Property and Rights Under this Security Instrument. If (a) Borrower fails to perform the covenants and agreements contained in this Security Instrument, (b) there is a legal proceeding that might significantly affect Lender's interest in the Property and/or rights under this Security Instrument (such as a proceeding in bankruptcy, probate, for condemnation or forfeiture, for enforcement of a lien which may attain priority over this Security Instrument or to enforce laws or regulations), or (c) Borrower has abandoned the Property, then Lender may do and pay for whatever is reasonable or appropriate to protect Lender's interest in the Property and rights under this Security Instrument, including protecting and/or assessing the value of the Property, and securing and/or repairing the Property. Lender's actions can include, but are not limited to: (a) paying any sums secured by a lien which has priority over this Security Instrument; (b) appearing in court; and (c) paying reasonable attorneys' fees to protect its interest in the Property and/or rights under this Security Instrument, including its secured position in a bankruptcy proceeding. Securing the Property includes, but is not limited to, entering the Property to make repairs, change locks, replace or board up doors and windows, drain water from pipes, eliminate building or other code violations or dangerous conditions, and have utilities turned on or off. Although Lender may take action under this Section 9, Lender does not have to do so and is not under any duty or obligation to do so. It is agreed that Lender incurs no liability for not taking any or all actions authorized under this Section 9.

Any amounts disbursed by Lender under this Section 9 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment.

If this Security Instrument is on a leasehold, Borrower shall comply with all the provisions of the lease. If Borrower acquires fee title to the Property, the leasehold and the fee title shall not merge unless Lender agrees to the merger in writing.

10. Mortgage Insurance. If Lender required Mortgage Insurance as a condition of making the Loan, Borrower shall pay the premiums required to maintain the Mortgage Insurance in effect. If, for any reason, the Mortgage Insurance coverage required by Lender ceases to be available from the mortgage insurer that previously provided such insurance and Borrower was required to make separately designated payments toward the premiums for Mortgage Insurance, Borrower shall pay the premiums required to obtain coverage substantially equivalent to the Mortgage Insurance previously in effect, at a cost substantially equivalent to the cost to Borrower of the Mortgage Insurance previously in effect, from an alternate mortgage insurer selected by Lender. If substantially equivalent Mortgage Insurance coverage is not available, Borrower shall continue to pay to Lender the amount of the separately designated payments that were due when the insurance coverage ceased to be in effect. Lender will accept, use and retain these payments as a non-refundable loss reserve in lieu of Mortgage Insurance. Such loss reserve shall be non-refundable, notwithstanding the fact that the Loan is ultimately paid in full, and Lender shall not be required to pay Borrower any interest or earnings on such loss reserve. Lender can no longer require loss reserve payments if Mortgage Insurance coverage (in the amount and for the period that Lender requires) provided by an insurer selected by Lender again becomes available, is obtained, and Lender requires separately designated payments toward the premiums for Mortgage Insurance. If Lender required Mortgage Insurance as a condition of making the Loan and Borrower was required to make separately designated payments toward the premiums for Mortgage Insurance, Borrower shall pay the premiums required to maintain Mortgage Insurance in effect, or to provide a non-refundable loss reserve, until Lender's requirement for Mortgage Insurance ends in accordance with any written agreement between Borrower and Lender providing for such termination or until termination is required by Applicable Law. Nothing in this Section 10 affects Borrower's obligation to pay interest at the rate provided in the Note.

Mortgage Insurance reimburses Lender (or any entity that purchases the Note) for certain losses it may incur if Borrower does not repay the Loan as agreed. Borrower is not a party to the Mortgage Insurance.

Mortgage insurers evaluate their total risk on all such insurance in force from time to time, and may enter into agreements with other parties that share or modify their risk, or reduce losses. These agreements are on terms and conditions that are satisfactory to the mortgage insurer and the other party (or parties) to these agreements. These agreements may require the mortgage insurer to make payments using any source of funds that the mortgage insurer may have available (which may include funds obtained from Mortgage Insurance premiums).

As a result of these agreements, Lender, any purchaser of the Note, another insurer, any reinsurer, any other entity, or any affiliate of any of the foregoing, may receive (directly or indirectly) amounts that derive from (or might be characterized as) a portion of Borrower's payments for Mortgage Insurance, in exchange for sharing or modifying the mortgage insurer's risk, or reducing losses. If such agreement provides that an affiliate of Lender takes a share of the insurer's risk in exchange for a share of the premiums paid to the insurer, the arrangement is often termed "captive reinsurance." Further:

(a) Any such agreements will not affect the amounts that Borrower has agreed to pay for Mortgage Insurance, or any other terms of the Loan. Such agreements will not increase the amount Borrower will owe for Mortgage Insurance, and they will not entitle Borrower to any refund.

(b) Any such agreements will not affect the rights Borrower has - if any - with respect to the Mortgage Insurance under the Homeowners Protection Act of 1998 or any other law. These rights may include the right to receive certain disclosures, to request and obtain cancellation of the Mortgage Insurance, to have the Mortgage Insurance terminated automatically, and/or to receive a refund of any Mortgage Insurance premiums that were unearned at the time of such cancellation or termination.

11. Assignment of Miscellaneous Proceeds; Forfeiture. All Miscellaneous Proceeds are hereby assigned to and shall be paid to Lender.

If the Property is damaged, such Miscellaneous Proceeds shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened. During such repair and restoration period, Lender shall have the right to hold such Miscellaneous Proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender may pay for the repairs and restoration in a single disbursement or in a series of progress payments as the work is completed. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such Miscellaneous Proceeds, Lender shall not be required to pay Borrower any interest or earnings on such Miscellaneous Proceeds. If the restoration or repair is not economically feasible or Lender's security would be lessened, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such Miscellaneous Proceeds shall be applied in the order provided for in Section 2.

In the event of a total taking, destruction, or loss in value of the Property, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower.

In the event of a partial taking, destruction, or loss in value of the Property in which the fair market value of the Property immediately before the partial taking, destruction, or loss in value is equal to or greater than the amount of the sums secured by this Security Instrument immediately before the partial taking, destruction, or loss in value, unless Borrower and Lender otherwise agree in writing, the sums secured by this Security Instrument shall be reduced by the amount of the Miscellaneous Proceeds multiplied by the following fraction: (a) the total amount of the sums secured immediately before the partial taking, destruction, or loss in value divided by (b) the fair market value of the Property immediately before the partial taking, destruction, or loss in value. Any balance shall be paid to Borrower.

In the event of a partial taking, destruction, or loss in value of the Property in which the fair market value of the Property immediately before the partial taking, destruction, or loss in value is less than the amount of the sums secured immediately before the partial taking, destruction, or loss in value, unless Borrower and Lender otherwise agree in writing, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument whether or not the sums are then due.

If the Property is abandoned by Borrower, or if, after notice by Lender to Borrower that the Opposing Party (as defined in the next sentence) offers to make an award to settle a claim for damages, Borrower fails to respond to Lender within 30 days after the date the notice is given, Lender is authorized to collect and apply the Miscellaneous Proceeds either to restoration or repair of the Property or to the sums secured by this Security Instrument, whether or not then due. "Opposing Party" means the third party that owes Borrower Miscellaneous Proceeds or the party against whom Borrower has a right of action in regard to Miscellaneous Proceeds.

Borrower shall be in default if any action or proceeding, whether civil or criminal, is begun that, in Lender's judgment, could result in forfeiture of the Property or other material impairment of Lender's interest in the Property or rights under this Security Instrument. Borrower can cure such a default and, if acceleration has occurred, reinstate as provided in Section 19, by causing the action or proceeding to be dismissed with a ruling that, in Lender's judgment, precludes forfeiture of the Property or other material impairment of Lender's interest in the Property or rights under this Security Instrument. The proceeds of any award or claim for damages that are attributable to the impairment of Lender's interest in the Property are hereby assigned and shall be paid to Lender.

All Miscellaneous Proceeds that are not applied to restoration or repair of the Property shall be applied in the order provided for in Section 2.

12. Borrower Not Released; Forbearance By Lender Not a Waiver. Extension of the time for payment or modification of amortization of the sums secured by this Security Instrument granted by Lender to Borrower or any Successor in Interest of Borrower shall not operate to release the liability of Borrower or any Successors in Interest of Borrower. Lender shall not be required to commence proceedings against any Successor in Interest of Borrower or to refuse to extend time for payment or otherwise modify amortization of the sums secured by this Security Instrument by reason of any demand made by the original Borrower or any

Successors in Interest of Borrower. Any forbearance by Lender in exercising any right or remedy including, without limitation, Lender's acceptance of payments from third persons, entities or Successors in Interest of Borrower or in amounts less than the amount then due, shall not be a waiver of or preclude the exercise of any right or remedy.

13. **Joint and Several Liability; Co-signers; Successors and Assigns Bound.** Borrower covenants and agrees that Borrower's obligations and liability shall be joint and several. However, any Borrower who co-signs this Security Instrument but does not execute the Note (a "co-signer"): (a) is co-signing this Security Instrument only to mortgage, grant and convey the co-signer's interest in the Property under the terms of this Security Instrument; (b) is not personally obligated to pay the sums secured by this Security Instrument; and (c) agrees that Lender and any other Borrower can agree to extend, modify, forbear or make any accommodations with regard to the terms of this Security Instrument or the Note without the co-signer's consent.

Subject to the provisions of Section 18, any Successor in Interest of Borrower who assumes Borrower's obligations under this Security Instrument in writing, and is approved by Lender, shall obtain all of Borrower's rights and benefits under this Security Instrument. Borrower shall not be released from Borrower's obligations and liability under this Security Instrument unless Lender agrees to such release in writing. The covenants and agreements of this Security Instrument shall bind (except as provided in Section 20) and benefit the successors and assigns of Lender.

14. **Loan Charges.** Lender may charge Borrower fees for services performed in connection with Borrower's default, for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument, including, but not limited to, attorneys' fees, property inspection and valuation fees. In regard to any other fees, the absence of express authority in this Security Instrument to charge a specific fee to Borrower shall not be construed as a prohibition on the charging of such fee. Lender may not charge fees that are expressly prohibited by this Security Instrument or by Applicable Law.

If the Loan is subject to a law which sets maximum loan charges, and that law is finally interpreted so that the interest or other loan charges collected or to be collected in connection with the Loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from Borrower which exceeded permitted limits will be refunded to Borrower. Lender may choose to make this refund by reducing the principal owed under the Note or by making a direct payment to Borrower. If a refund reduces principal, the reduction will be treated as a partial prepayment without any prepayment charge (whether or not a prepayment charge is provided for under the Note). Borrower's acceptance of any such refund made by direct payment to Borrower will constitute a waiver of any right of action Borrower might have arising out of such overcharge.

15. **Notices.** All notices given by Borrower or Lender in connection with this Security Instrument must be in writing. Any notice to Borrower in connection with this Security Instrument shall be deemed to have been given to Borrower when mailed by first class mail or when actually delivered to Borrower's notice address if sent by other means. Notice to any one Borrower shall constitute notice to all Borrowers unless Applicable Law expressly requires otherwise. The notice address shall be the Property Address unless Borrower has designated a substitute notice address by notice to Lender. Borrower shall promptly notify Lender of Borrower's change of address. If Lender specifies a procedure for reporting Borrower's change

of address, then Borrower shall only report a change of address through that specified procedure. There may be only one designated notice address under this Security Instrument at any one time. Any notice to Lender shall be given by delivering it or by mailing it by first class mail to Lender's address stated herein unless Lender has designated another address by notice to Borrower. Any notice in connection with this Security Instrument shall not be deemed to have been given to Lender until actually received by Lender. If any notice required by this Security Instrument is also required under Applicable Law, the Applicable Law requirement will satisfy the corresponding requirement under this Security Instrument.

16. Governing Law; Severability; Rules of Construction. This Security Instrument shall be governed by federal law and the law of the jurisdiction in which the Property is located. All rights and obligations contained in this Security Instrument are subject to any requirements and limitations of Applicable Law. Applicable Law might explicitly or implicitly allow the parties to agree by contract or it might be silent, but such silence shall not be construed as a prohibition against agreement by contract. In the event that any provision or clause of this Security Instrument or the Note conflicts with Applicable Law, such conflict shall not affect other provisions of this Security Instrument or the Note which can be given effect without the conflicting provision.

As used in this Security Instrument: (a) words of the masculine gender shall mean and include corresponding neuter words or words of the feminine gender; (b) words in the singular shall mean and include the plural and vice versa; and (c) the word "may" gives sole discretion without any obligation to take any action.

17. Borrower's Copy. Borrower shall be given one copy of the Note and of this Security Instrument.

18. Transfer of the Property or a Beneficial Interest in Borrower. As used in this Section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.

If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.

If Lender exercises this option, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

19. Borrower's Right to Reinstate After Acceleration. If Borrower meets certain conditions, Borrower shall have the right to have enforcement of this Security Instrument discontinued at any time prior to the earliest of: (a) five days before sale of the Property pursuant to any power of sale contained in this Security Instrument; (b) such other period as Applicable Law might specify for the termination of Borrower's right to reinstate; or (c) entry of a judgment enforcing this Security Instrument. Those conditions are that Borrower: (a) pays Lender all sums which then would be due under this Security Instrument and the Note as if no acceleration had occurred; (b) cures any default of any other covenants or agreements; (c) pays all expenses incurred in enforcing this Security Instrument, including, but not limited to, reasonable attorneys' fees, property inspection and valuation fees, and other fees incurred for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument; and (d) takes such action as Lender may reasonably require to assure that Lender's interest in the Property and rights under this Security Instrument, and Borrower's obligation to pay the sums secured by this Security Instrument, shall continue unchanged. Lender may require that Borrower pay such reinstatement sums and expenses in one or more of the following forms, as selected by Lender: (a) cash; (b) money order; (c) certified check, bank check, treasurer's check or cashier's check, provided any such check is drawn upon an institution whose deposits are insured by a federal agency, instrumentality or entity; or (d) Electronic Funds Transfer. Upon reinstatement by Borrower, this Security Instrument and obligations secured hereby shall remain fully effective as if no acceleration had occurred. However, this right to reinstate shall not apply in the case of acceleration under Section 18.

20. Sale of Note; Change of Loan Servicer; Notice of Grievance. The Note or a partial interest in the Note (together with this Security Instrument) can be sold one or more times without prior notice to Borrower. A sale might result in a change in the entity (known as the "Loan Servicer") that collects Periodic Payments due under the Note and this Security Instrument and performs other mortgage loan servicing obligations under the Note, this Security Instrument, and Applicable Law. There also might be one or more changes of the Loan Servicer unrelated to a sale of the Note. If there is a change of the Loan Servicer, Borrower will be given written notice of the change which will state the name and address of the new Loan Servicer, the address to which payments should be made and any other information RESPA requires in connection with a notice of transfer of servicing. If the Note is sold and thereafter the Loan is serviced by a Loan Servicer other than the purchaser of the Note, the mortgage loan servicing obligations to Borrower will remain with the Loan Servicer or be transferred to a successor Loan Servicer and are not assumed by the Note purchaser unless otherwise provided by the Note purchaser.

Neither Borrower nor Lender may commence, join, or be joined to any judicial action (as either an individual litigant or the member of a class) that arises from the other party's actions pursuant to this Security Instrument or that alleges that the other party has breached any provision of, or any duty owed by reason of, this Security Instrument, until such Borrower or Lender has notified the other party (with such notice given in compliance with the requirements of Section 15) of such alleged breach and afforded the other party hereto a reasonable period after the giving of such notice to take corrective action. If Applicable Law provides a time period which must elapse before certain action can be taken, that time period will be deemed to be reasonable for purposes of this paragraph. The notice of acceleration and opportunity to cure given to Borrower pursuant to Section 22 and the notice of acceleration given to Borrower pursuant to Section 18 shall be deemed to satisfy the notice and opportunity to take corrective action provisions of this Section 20.

21. Hazardous Substances. As used in this Section 21: (a) "Hazardous Substances" are those substances defined as toxic or hazardous substances, pollutants, or wastes by Environmental Law and the following substances: gasoline, kerosene, other flammable or toxic petroleum products, toxic pesticides and herbicides, volatile solvents, materials containing asbestos or formaldehyde, and radioactive materials; (b) "Environmental Law" means federal laws and laws of the jurisdiction where the Property is located that relate to health, safety or environmental protection; (c) "Environmental Cleanup" includes any response action, remedial action, or removal action, as defined in Environmental Law; and (d) an "Environmental Condition" means a condition that can cause, contribute to, or otherwise trigger an Environmental Cleanup.

Borrower shall not cause or permit the presence, use, disposal, storage, or release of any Hazardous Substances, or threaten to release any Hazardous Substances, on or in the Property. Borrower shall not do, nor allow anyone else to do, anything affecting the Property (a) that is in violation of any Environmental Law, (b) which creates an Environmental Condition, or (c) which, due to the presence, use, or release of a Hazardous Substance, creates a condition that adversely affects the value of the Property. The preceding two sentences shall not apply to the presence, use, or storage on the Property of small quantities of Hazardous Substances that are generally recognized to be appropriate to normal residential uses and to maintenance of the Property (including, but not limited to, hazardous substances in consumer products).

Borrower shall promptly give Lender written notice of (a) any investigation, claim, demand, lawsuit or other action by any governmental or regulatory agency or private party involving the Property and any Hazardous Substance or Environmental Law of which Borrower has actual knowledge, (b) any Environmental Condition, including but not limited to, any spilling, leaking, discharge, release or threat of release of any Hazardous Substance, and (c) any condition caused by the presence, use or release of a Hazardous Substance which adversely affects the value of the Property. If Borrower learns, or is notified by any governmental or regulatory authority, or any private party, that any removal or other remediation of any Hazardous Substance affecting the Property is necessary, Borrower shall promptly take all necessary remedial actions in accordance with Environmental Law. Nothing herein shall create any obligation on Lender for an Environmental Cleanup.

NON-UNIFORM COVENANTS. Borrower and Lender further covenant and agree as follows:

22. Acceleration; Remedies. Lender shall give notice to Borrower prior to acceleration following Borrower's breach of any covenant or agreement in this Security Instrument (but not prior to acceleration under Section 18 unless Applicable Law provides otherwise). The notice shall specify: (a) the default; (b) the action required to cure the default; (c) a date, not less than 30 days from the date the notice is given to Borrower, by which the default must be cured; and (d) that failure to cure the default on or before the date specified in the notice may result in acceleration of the sums secured by this Security Instrument and sale of the Property. The notice shall further inform Borrower of the right to reinstate after acceleration and the right to bring a court action to assert the non-existence of a default or any other defense of Borrower to acceleration and sale. If the default is not cured on or before the date specified in the notice, Lender at its option may require immediate payment in full of all sums secured by this Security Instrument without further demand and may invoke the power of sale and any other remedies permitted by Applicable Law. Lender shall be entitled to collect all expenses incurred in pursuing the remedies provided in this Section 22, including, but not limited to, reasonable attorneys' fees and costs of title evidence.

If Lender invokes the power of sale, Lender shall execute or cause Trustee to execute a written notice of the occurrence of an event of default and of Lender's election to cause the Property to be sold. Trustee shall cause this notice to be recorded in each county

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in which any part of the Property is located. Lender or Trustee shall mail copies of the notice as prescribed by Applicable Law to Borrower and to the other persons prescribed by Applicable Law. Trustee shall give public notice of sale to the persons and in the manner prescribed by Applicable Law. After the time required by Applicable Law, Trustee, without demand on Borrower, shall sell the Property at public auction to the highest bidder at the time and place and under the terms designated in the notice of sale in one or more parcels and in any order Trustee determines. Trustee may postpone sale of all or any parcel of the Property by public announcement at the time and place of any previously scheduled sale. Lender or its designee may purchase the Property at any sale.

Trustee shall deliver to the purchaser Trustee's deed conveying the Property without any covenant or warranty, expressed or implied. The recitals in the Trustee's deed shall be prima facie evidence of the truth of the statements made therein. Trustee shall apply the proceeds of the sale in the following order: (a) to all expenses of the sale, including, but not limited to, reasonable Trustee's and attorneys' fees; (b) to all sums secured by this Security Instrument; and (c) any excess to the person or persons legally entitled to it.

23. Reconveyance. Upon payment of all sums secured by this Security Instrument, Lender shall request Trustee to reconvey the Property and shall surrender this Security Instrument and all notes evidencing debt secured by this Security Instrument to Trustee. Trustee shall reconvey the Property without warranty to the person or persons legally entitled to it. Lender may charge such person or persons a reasonable fee for reconveying the Property, but only if the fee is paid to a third party (such as the Trustee) for services rendered and the charging of the fee is permitted under Applicable Law. If the fee charged does not exceed the fee set by Applicable Law, the fee is conclusively presumed to be reasonable.

24. Substitute Trustee. Lender, at its option, may from time to time appoint a successor trustee to any Trustee appointed hereunder by an instrument executed and acknowledged by Lender and recorded in the office of the Recorder of the county in which the Property is located. The instrument shall contain the name of the original Lender, Trustee and Borrower, the book and page where this Security Instrument is recorded and the name and address of the successor trustee. Without conveyance of the Property, the successor trustee shall succeed to all the title, powers and duties conferred upon the Trustee herein and by Applicable Law. This procedure for substitution of trustee shall govern to the exclusion of all other provisions for substitution.

25. Statement of Obligation Fee. Lender may collect a fee not to exceed the maximum amount permitted by Applicable Law for furnishing the statement of obligation as provided by Section 2943 of the Civil Code of California.

BY SIGNING BELOW, Borrower accepts and agrees to the terms and covenants contained in this Security Instrument and in any Rider executed by Borrower and recorded with it.

Witnesses:

____________________________ ____________________________(Seal)
- Borrower

____________________________ ____________________________(Seal)
- Borrower

________________[Space Below This Line for Acknowledgment]________________

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LOAN CLAUSES AND TERMS

A number of special provisions may be included in trust deeds, mortgages, and promissory notes. Most are designed to protect the lender or the borrower, in various situations.

PURCHASE MONEY

This term refers to actual money or credit used to acquire the property made as security for the loan.

- **Seller Financing** – Any secured credit extended by a seller is **"**purchase money.**"**
- **Refinancing** – Refinancing of any kind is ***not*** **"**purchase money.**"**
- **Transferability** – Once a loan is **"**purchase money,**"** the sale of the note or assumption of the debt does not change its status.
- **Limitations** – No deficiency judgment on purchase money is allowed if the lien was created by:
  - Credit extended by the seller.
  - Financing used to purchase an owner–occupied dwelling of 4 units or less.
- **Effect** – The effect of these statutory limitations is to give limited liability to the home buyer. Thus, there is less risk to borrowing money for purchase of a home than for any other purpose.

ACCELERATION CLAUSE

An **acceleration clause** gives the lender the right to **"**call**"** all sums owed to the lender, immediately due and payable upon the happening of certain specified events.

Due–on–Sale Clause

An **alienation clause** (also known as due–on–sale clause) is a special kind of acceleration clause permitting the lender to call the loan if the borrower alienates (conveys or transfers) title. The clause must be stated specifically in the note as well as the trust deed to be enforceable. Benefits the lender.

- **Federal Statute** – The Garn–St. Germain Depository Institutions Act of 1982 preempted state prohibitions on the exercise of due–on–sale clauses by all lenders.
- **Due–On–Sale Now Enforceable** – On October 15, 1985, all grace periods terminated, and due–on–sale clauses generally became enforceable except in very limited prescribed circumstances.
- **Exemptions** – On loans secured by liens on residential property of less than 5 units, a lender may not exercise a due–on–sale clause upon:
    - Creation of a junior lien
    - Creation of a purchase money security interest for household appliances
    - The death of a joint tenant
    - A lease of 3 years or less not containing an option to purchase Transfer to a relative upon death of the borrower
    - A transfer to the spouse or children of the borrower
    - Dissolution of marriage
    - Transfer into an inter vivos trust with no transfer of occupancy.

Assignment of Rents Clause

The standard short form for recording is called “deed of trust and assignment of rents.” This clause is normal in most trust deeds.

This clause provides that upon default by the trustor, the beneficiary may take possession of the property through a court appointed trustee and collect rents applying them to the loan and to the costs and expenses incurred.

Prepayment Penalty Clause

A penalty imposed on the borrower, stated in the note and trust deed, for early payoff of the loan or any substantial part thereof. Termed **"**punitive interest**"** and tax deductible as such. Benefits the lender.

This penalty is usually specified as a certain number of months' interest on the unpaid balance to be paid in addition to the amount owed to date. The amounts and times are limited by law in California.

- **Civil Code** – For owner–occupied homes, the penalty is restricted during the first 5 years as follows:
    - Up to 20% of original loan amount may be prepaid in any 12–month period without penalty.
    - For amounts paid over this the borrower may be charged no more than six months' interest penalty.
- **Real Estate Law** – Loans regulated by Article 7 of the Real Estate law (those negotiated by real estate brokers) have slightly different prepayment penalty limitations on owner–occupied single–family dwellings, and may extend through 7 years.
    - Up to 20% of the unpaid balance may be prepaid in any 12–month period.
    - For amounts paid over this the borrower may be charged no more than six months' interest penalty.

Or More Clause

An **or more clause** specifies that the borrower may pay more than the required periodic payment specified in the note, including the right to pay off the entire balance at any time. A note containing an **"**or more**"** clause may or may not have a prepayment penalty. Benefits the borrower.

Partial Release Clause

A **partial release clause** provides for reconveyance of each lot by the beneficiary as each lot is sold, when the encumbrance covers two or more parcels.

Subordination Clause

A **subordination clause** is an agreement that the lender will relinquish priority to a subsequent lien. The clause is generally used to subordinate the loan to a construction loan to be obtained later. Benefits the borrower.

Power of Sale Clause

A **power of sale clause** enables nonjudicial sale of property possible in the event of default by the borrower. Properly written trust deeds always contain a power of sale. Mortgages generally must be foreclosed judicially, unless a power of sale clause has been specially incorporated. Benefits the lender.

Balloon Payment Clause

A balloon payment, by Civil Code definition is that more than double the amount of a regular installment is,. In a balloon mortgage say, if the amortization period is 15 years, but the entire unpaid balance is due at the end of say 5 or 7 years.

The balloon payment mortgage, although used in financing commercial properties, has not met with huge success in financing homes because of the balloon feature. Unless the note calls for a rollover, there is no assurance that the loan will be rewritten with a new rate at maturity. Thus balloon payment home loans are frequently seller carryback loans used during tight or high–interest, mortgage markets.

☞ ***A balloon loan provides the "balance" is all due and payable at a specified time.***

Figure 8-1 Comparison of Trust Deed and Mortgage

	Trust Deed	**Mortgage**
Parties	Three Parties Trustor: The borrower who signs the note and trust deed and conveys title to	Two Parties Mortgagor: The borrower who signs the note and retains the

	trustee. Remains equitable owner. Beneficiary The lender who holds note and trust deed. Trustee: (neutral third party) The receiver of “naked legal title” from trustor (authorization to sell in the event of default). He will reconvey title when the debt is paid, or sell through a trustee’s sale.	legal title. Has possession and use. Mortgagee: The lender who holds the note and mortgage contract.
Payment in Full	Note and trust deed is sent to a trustee by beneficiary, who signs a ***“****Request for Full Reconveyance.****”*** A trustee signs and issues a reconveyance deed, which is recorded to clear the lien from the public records. A reconveyance deed does not convey title to a new buyer.	When loan is paid, mortgagee issues a ***“****Certificate of Discharge,****”*** which is recorded to clear the lien from the public records.
Title	Conveyed to trustee with trustor retaining possession of the property.	Retained by mortgagor together with possession.
Default Breach	Beneficiary can choose either a trustee’s sale (most expedient–requires about four months) or a foreclosure through the courts. If foreclosed through the courts, the court foreclosure rules apply.	Can usually be foreclosed only through the judicial court foreclosure, unless the mortgage contains a power of sale clause.
Statute of Limitation	There is no time limit since trustee has title and power of sale.	Foreclosure is barred if no action is taken within four years of delinquency. Mortgage is said to have “outlawed.”
Foreclosure	Trustee’s Sale 1.Beneficiary notifies trustee default. 2.Trustee records “*Notice of Default*” and notifies trustor, subsequent	Mortgage Sale Court Foreclosure Sale 1.Mortgagee brings court action.

	recorded lienors and all others who have requested notice. 3.Trustee waits at least three months. During three–month period, trustor can reinstate loan. 4.After three months, trustee advertises **"**notice of sale**"** in a newspaper of general circulation once a week for three weeks and posts notice on property. 5.Trustor can reinstate the loan (pay the back payments and penalties) up until five days before the sale. 6.Trustee conducts sale and issues a trustee's deed to the highest bidder. Note: Trustor owns and possesses property until the sale and could redeem it or sell it him or herself.	2.Court orders property sold. 3.Commissioner appointed by the court advertises **"**notice of sale**"** once a week for three weeks and posts notice on property. 4.A certificate of sale is issued at time of sale to the buyer. 5.Mortgagor has one year to redeem property (pay loan in full, statutory right of redemption) and to remain in possession (liable for reasonable rent). 6.A sheriff's deed is issued one year after the sale.
Redemption Right	When title has been sold by trustee at trustee's sale, no right of redemption exists.	Mortgagor has up to one year to redeem following court foreclosure; called **"***Equity of Redemption.***"**
Deficiency Judgment	Not available if: 1.The foreclosure is by the trustee's sale. 2.On purchase money trust deeds.	Available in a court foreclosure unless the mortgage was a purchase money mortgage.

EFFECTS OF SECURITY

A security interest such as a mortgage or trust deed affects the borrower's ability to transfer the property, creates a creditor's interest which can be transferred, and imposes certain conditions regarding liens and termination of the interest.

ASSIGNMENT BY CREDITOR

These security instruments can be transferred like any other property or instrument. However, the note and the security device must go together.

- **Inseparable Instruments** – The assignment of a note requires the assignment of the security interest, and vice versa.
    - An attempted assignment of the security interest without the note transfers nothing to the assignee.
    - A transfer of the note without the mortgage or trust deed gives the assignee the right to the security.
- **Recording** – Any assignment of the security interest in a mortgage or trust deed may be recorded. This recording gives constructive notice of assignment. After an assignment is recorded, the debtor is not protected if making payments to the original creditor instead of the assignee.

TRANSFER OF PROPERTY

Upon transfer of property which has been mortgaged, the property still remains subject to the mortgage.

- **Assumption** – By assumption of an existing debt the grantee becomes the primary debtor. Secondary liability still exists, however, for the original borrower unless released by the lender.
    - The person granted the property (grantee) cannot be held liable for a deficiency judgment unless the grantee assumed the mortgage.
    - The mortgagor is still liable for payments to the mortgagee despite the grant unless given a release of liability.
    - For certain purchase money loans, remedy of the mortgagee is against the property only (no deficiency judgment).
- **In Writing** – Any agreement by a buyer to pay a debt secured by a mortgage must be in writing.
- **Beneficiary Statement** – A "beneficiary statement" is obtained when a new purchaser acquires a mortgage or trust deed which already exists. Furnished by the lender, it is a statement of the current condition of the debt containing:

- Unpaid balance
- Interest payments
- Any other claims that do not appear in the instrument

SATISFACTION OF DEBT

A mortgage or trust deed should be terminated when the debt is satisfied.

- **Full Payment by the Debtor** – Signified by cancellation of the note and issuance of the reconveyance deed or satisfaction of mortgage. The lien is removed from the property when the release instrument is recorded.
- **Foreclosure Sale** – If the debtor fails to pay, foreclosure is accomplished either out of court (no deficiency judgment) or in court (deficiency judgment possible except in the case of most purchase money trust deeds).

LIEN PRIORITIES

Liens take precedence usually in the order of recordation time, unless modified by a subordination clause or by operation of law, as in the case of a mechanics lien or a judgment lien.

- **Legal Notice** – The concept of notice is an important element in establishing priority. It can be:
  - Actual notice (express or implied).
  - Constructive notice (recordation or possession).
- **Tax liens** – Taxes and assessments are usually on a par with each other and take priority over other liens including a trust deed or mortgage.

Form 8-1: Note Secured By Deed Of Trust

NOTE SECURED BY DEED OF TRUST

(INSTALLMENT–INTEREST INCLUDED)

$__________ ________________California,________________________

In installments as herein stated, for value received, I promise to pay to or order,

____

At ____

____

the sum of __________________________________DOLLARS,

with interest from____ on unpaid

principal at the rate of____________________ per cent per annum; principal

and interest payable in installments of __________________________________

________________Dollars or more on the_______________________ day of

each month, beginning _____________on the day of _____________________

and continuing until said principal and interest have been paid.

Each payment shall he *credited* first on interest then due and the remainder on principal; and interest shall thereupon cease upon the principal so credited. Should interest not be so paid it shall thereafter bear like interest as the principal, but such unpaid interest so compounded shall not exceed an amount equal to simply interest on the unpaid principal at the maximum rate permitted by law. Should default he made in payment of any installment of principal or interest when due the whole sum of principal and interest shall become immediately due at the option of the holder of this note. Principal and interest payable in lawful money of the United States. If action be instituted on this note I promise to pay such sum as the Court may fix as attorney's fees. This note is secured by a DEED OF TRUST to Title INSURANCE AND TRUST COMPANY, a California corporation, as Trustee.

______________________________________ ______________________

______________________________________ ______________________

THIS FORM FURNISHED BY TITLE INSURANCE AND TRUST COMPANY

Do not destroy this note. When paid, said Original Note, together with the Deed of Trust securing same, must be surrendered to Trustee for Cancellation and retention before reconveyance will be made.

CHAPTER QUIZ

1. A person who is an innocent purchaser of a negotiable note for value without knowledge of any defect is customarily called:

   A A holder in due course
   B An assignor
   C A receiver in trust
   D. An endorser in blank

2. A fictitious deed of trust is:

   A. Trust deed recorded against a single title to real property
   B. Forged trust deed
   C. It does not cite a specific property
   D. Recorded form of trust deed referred to in other trust deeds subsequently recorded in that county

3. Reinstatement under a trust deed is possible:

   A. Up to 5 business days prior to sale
   B. Anytime prior to sale
   C. Within 3 months after sale
   D. Up to 1 year after sale depending on sale proceeds

4. A note and mortgage requires a borrower to protect the lender by paying all of the following, ***except***:

   A. Property taxes
   B. Life insurance premiums for borrower
   C. Hazard insurance premiums
   D. Principal and interest payments

5. A trust deed that is in default may be foreclosed:

   A. Only by going to court
   B. By exercising the power of sale or by going to court
   C. By trustee's sale only
   D. None of the above

6. When a borrower has defaulted on a loan, and the lender chooses judicial foreclosure, the mortgagor is given a specified period of time to redeem the

property. During this redemption period, the right of possession of the property is held by the:

A. Mortgagee;
B. Court-appointed trustee;
C. Beneficiary;
D. Mortgagor.

7. An alienation clause:

A. Is a due–on–sale clause”
B. Conveys the title of a property to a transferee
C. Gives a lender the right to “call” a loan
D. Both A and C

8. A deficiency judgment may be granted by a court for a loan which is:

A. Used for the purchase of an owner–occupied dwelling
B. For a second trust deed note secured at the time of purchase, foreclosed upon a personal residence
C. A refinance on an owner–occupied residence for the purpose of home improvements
D. None of the above

9. Under the Uniform Commercial Code, when an individual has satisfied a debt, the document that releases the lien of a previously filed financing statement is a:

A. Satisfaction of mortgage
B. Termination statement
C. Reconveyance
D. Paid–in–full statement

10. The Garn–St. Germain Act preempted state regulations on due–on–sale clauses and prescribes that due–on–sale clauses:

A Are not enforceable
B Are enforceable only in mortgages
C Are enforceable only in trust deeds
D Are enforceable with certain exceptions

Answer Key: 1–A, 2–C, 3–A, 4–B, 5–C, 6–D, 7–D, 8–D, 9–C, 10–A

CHAPTER 9: FIXED RATE MORTGAGE AND ALTERNATIVE MORTGAGE INSTRUMENTS

PREVIEW

This chapter is designed to distinguish between fixed rate mortgage and another type of mortgage instrument, the alternative mortgage instrument from the standard mortgage instrument. We will talk about the reasons behind the expanded use of alternative mortgage instruments. We will talk about Adjustable rate mortgage, convertible ARM, buy–down mortgage, graduated payment mortgage, growing equity mortgage. Shared–appreciation mortgage and Reverse Annuity mortgage.

Adjustable rate mortgages (ARMs) and other alternative mortgage instruments (AMIs) are financing instruments that compete against the standard fixed rate, fully amortized loan program. This competition has been evolving for over 30 years.

TYPES OF MORTGAGES

Although the characteristics of the two instruments vary, in this book the word "mortgage" will be used interchangeably with "deed of trust."

The many types of mortgages can be divided into two distinct groups: alternative mortgages and standard mortgages. In alternative mortgages at least one of the four basic characteristics of a deed of trust is varied. Those characteristics are:

1. Interest rate
2. Payments, varied by time or amount
3. Repayment term
4. Negative amortization

With a standard deed of trust, characteristics 1 through 3 do not change. The amount of principal, however, decreases with each payment.

FIXED RATE MORTGAGE

The name of this standard mortgage is derived from the fact that the payments are constant over the life of the ban, thus the borrower may budget for or plan on a fixed payment. In addition to the fixed–payment feature of the ban, the borrower starts to build equity from the first payment. With the budget mortgage, the principal and interest (P & I) portion of the payment does not vary. The only variable in the payment is the amount needed to pay the taxes, insurance, private mortgage insurance, if any, and any other fees that if not paid may affect the title to the property. It should be noted that the amount that will be collected for the aforementioned or escrow's is the total amount due each year divided by 12.

Because the borrower starts to build equity with the first month's payment, let us calculate the amount of principal reduction and the amount of the interest charges for the first three payments of a 30–year, fixed–rate, fixed–term loan. The deed of trust amount is $85,000; the interest rate is 8 percent. The first step is to calculate the monthly payment. This can be done using several methods: a payment book, a financial calculator, or the use of monthly payment factors.

For this example, we are going to use the monthly payment factor. The monthly payment factor may be defined as an amount that is necessary to repay a loan of $1000 at a specific interest rate for a specific number of years. In this example we need the factor of a 30–year loan at 8 percent. In Appendix A, the monthly payment factors (MPF) are listed for 15–, 20–, 25–, and 30–year mortgages for interest rates from 7 to 17 percent. Find the proper interest rate of 8.125 percent in the first column, then go across the row under the proper heading that describes the term–30 years or 360 months in the far right column. The MPF is 7.4250. This means that we will repay the loan at the rate of $7.4250 per $1000 borrowed. To calculate the monthly payment (P & I only), we would multiple the monthly payment factor (MPF) times the loan amount divided by 1000, or

Monthly Payment = MPF x Loan Amount/1000

For our example we would then insert the proper numbers in the formula:
$7.4250 x $85,000 / 1000 = $631.125

Thus, the monthly payment for P & I only would equal $631.125 or $631.13.

Now let us calculate the amount of the first payment that will go to pay the interest charges and the amount of the payment that will be credited to principal reduction.

First, the interest payment. we calculate the amount of interest that would be charged on the loan amount for a full year.

$85,000 X 8.0% = $6,800

Because we only need the amount for 1 month, we divide this amount by 12 months or $6,800 / 12 = $566.67

Therefore, the interest payment for the first payment would be $566.67 and the remainder of the total payment of $631.13 – that is, $631.13 minus $566.67 or $64.46 – would be credited to principal reduction. Thus, the balance on the loan would be the original loan amount minus the $64.46 or $84,935. If you would like to calculate the amount of principal reduction for the second payment you would follow the same steps of multiplying the new loan amount by the annual interest rate of 8.0 percent (0.08) to get the annual interest that would be paid, dividing that answer by 12 to get the monthly interest, then subtracting that amount from the total P & I payment of $631.13, giving the amount that would go to principal reduction:

1. Annual interest: $84,935.54 x 8.0% = $6,794.84
2. Monthly Interest Charge: $6794.85 / 12 =$566.24
3. Principal Reduction: $631.13 – $566.24 = $64.89

These calculations show that in the first years of the loan the major portion of each payment goes to the payment of interest. Many times a borrower will ask, **"**How much will I pay back on my loan?**"** This is simple to calculate. Multiple the monthly payment for P & I times the total number of payments, or in this example $631.13 x 360 monthly payments for a total of $227,206.80 or approximately four times the amount borrowed.

To calculate the amount of interest that would be paid over the term of the loan, subtract the original loan amount from the total amount repaid or

$227,206.80 – $85,000 $142,206.80

With these simple steps and the monthly payment factors, a real estate professional can calculate the above for any fixed–rate (from 7 to 17 percent), fixed–term (15–, 20–, 25–, or 30–year) mortgage.

Figure 9-1: Monthly Payment Factors for $1000 Loan Amounts

Interest rate	15 years	20 years	25 years	30 years
7.000	8.9882	7.7530	7.0678	6.6530
7.125	9.0583	7.8282	7.1477	6.7372
7.250	9.1286	7.9038	7.2281	6.8218
7.375	9.1992	7.9797	7.3088	6.9067
7.500	9.2701	8.0559	7.3899	6.9921
7.625	9.3413	8.1325	7.4714	7.0779
7.750	9.4128	8.2095	7.5533	7.1641
7.875	9.4845	8.2868	7.6355	7.2507
8.000	9.5565	8.3644	7.7182	7.3376
8.125	9.6288	8.4424	7.8012	7.4250
8.250	9.7014	8.5207	7.8845	7.5127
8.375	9.7743	8.5993	7.9682	7.6007
8.500	9.8474	8.6782	8.0523	7.6891
8.625	9.9208	8.7575	8.1367	7.7779
8.750	9.9945	8.8371	8.2214	7.8670
8.875	10.0684	8.9170	8.3065	7.9565
9.000	10.1427	8.9973	8.3920	8.0462
9.125	10.2172	9.0778	8.4777	8.1363
9.250	10.2919	9.1587	8.5638	8.2268
9.375	10.3670	9.2398	8.6502	8.3175

9.500	10.4423	9.3213	8.7370	8.4085
9.625	10.5178	9.4031	8.8240	8.4999
9.750	10.5936	9.4852	8.9114	8.5915
9.875	10.6697	9.5675	8.9990	8.6835
10.000	10.7461	9.6502	9.0870	8.7757
10.125	10.8227	9.7332	9.1753	8.8682
10.250	10.8995	9.8164	9.2638	8.9610
10.375	10.9766	9.8999	9.3527	9.0541
10.500	11.0540	9.9838	9.4418	9.1474
10.625	11.1316	10.0679	9.5312	9.2410
10.750	11.2095	10.1523	9.6209	9.3348
10.875	11.2876	10.2370	9.7109	9.4289
11.000	11.3659	10.3219	9.8011	9.5232
11.125	11.4446	10.4070	9.8916	9.6178
11.250	11.5234	10.4926	9.9824	9.7126
11.375	11.6026	10.5783	10.0734	9.8077
11.500	11.6819	10.6643	10.1647	9.9029
11.625	11.7615	10.7506	10.2562	9.9984
11.750	11.8413	10.8371	10.3480	10.0941
11.875	11.9214	10.9238	10.4400	10.1900
12.000	12.0017	11.0109	10.5322	10.2861
12.125	12.0822	11.0981	10.6247	10.3824
12.250	12.1630	11.1856	10.7174	10.4790
12.375	12.2440	11.2734	10.8104	10.5757
12.500	12.3252	11.3614	10.9035	10.6726
12.625	12.4067	11.4673	11.0156	10.7697
12.750	12.4884	11.5381	11.0905	10.8669
12.875	12.5703	11.6268	11.1843	10.9644
13.000	12.6524	11.7158	11.2784	11.0620
13.125	12.7348	11.8049	11.3726	11.1598
13.250	12.8174	11.8943	11.4670	11.2577
13.375	12.9002	11.9839	11.5616	11.3558
13.500	12.9832	12.0737	11.6564	11.4541
13.625	13.0664	12.1638	11.7515	11.5525
13.750	13.1499	12.2541	11.8467	11.6511
13.875	13.2335	12.3445	11.9420	11.7498

ALTERNATIVE MORTGAGE INSTRUMENTS (AMI)

As mentioned earlier in **"**Types of Mortgages**"**, the alternative mortgage instrument (AMI) is one of the two basic types of mortgage instruments. (The other type is the standard mortgage instrument.) The alternative mortgage instrument is the type of mortgage in which at least one of the four basic mortgage characteristics varies. The importance of AMIs has grown in the last few years because the increase in home prices has meant that fewer persons can qualify for housing. In the past, AMIs were thought to be a creative method of financing the real estate transaction, but today they are becoming the standard.

The AMI is becoming more common in the real estate industry as interest rates continue to increase and/or funds for real estate financing become less available. The most important factor that makes this type of mortgage appeal to the lender is that it allows the lender's return from the mortgage to keep up with the prevailing interest rate. It appeals to the borrower because many of the AMIs allow the borrower to quality for a larger mortgage amount, by making the initial monthly payments lower and increasing them over a specified time as the borrowers income increases. Some of the more common AMIs and many of the newest AMIs will be discussed in this chapter.

ADJUSTABLE RATE MORTGAGES

In the 1970s over 50 different types of instruments were developed for financing with variable terms. These included the variable interest rate loan, roll–over mortgage, renegotiable rate mortgage, graduated payment mortgage, adjustable mortgage loan, and adjustable rate mortgage. Of these, the ARM has emerged the most widely used in California.

DRE REFERENCE BOOK

The **"Reference Book"** of the California Department of Real Estate outlines the origin and development of adjustable rate financing, and the consumer issues involved:

Since FHA created the long–term, fixed–rate amortized mortgage loan in 1934, that has been the standard traditional form of financing for home purchases. In a stable economic environment, involving little or no inflation and relatively constant market interest rates, these long–term, fixed–rate instruments should meet most of the practical needs of both lenders and borrowers.

Increased and unpredictable inflation rates and uncertain future interest rates have made "traditional" financing unsuitable for many lenders and unrealistic or impossible for many borrowers. If interest rates increase, forcing lenders to pay higher interest rates to attract deposits, those lenders who have invested in long–term, fixed–rate mortgage instruments at lower interest rates have a serious economic problem that could be ruinous. On the other hand, if lenders will make loans only at interest rates high enough to reduce this risk, borrowers generally will be less willing to borrow and fewer prospective borrowers will qualify for loans.

Alternative mortgage instruments are the means by which lenders and borrowers are responding to the realities of the economy. The peculiar needs of different kinds of lenders, as well as of the different classes of borrowers who are in need of credit to consummate home purchases (e.g., those borrowers whose incomes tend to keep pace with inflation, as distinguished from those whose dollar incomes do not increase sufficiently to maintain a constant real purchasing power), mean that there is no single optimum alternative mortgage plan that will suit all possible creditor–debtor combinations. The process of selecting the appropriate mortgage instrument in a particular situation is, therefore, one of enormous importance to both the lender and the borrower, and both should approach the mortgage selection process with great care and attention to the mutual needs and interests of themselves and the other party or parties.

Historically, lenders have a problem with cycles of tight and loose money. This unsteady flow of funds is disruptive to their operations and to the housing industry. When money is tight, it flows out of thrift institutions because depositors can obtain higher yields elsewhere–the phenomenon described in Chapter 2 as disintermediation.

Advocates of alternative loans say that this problem can be reduced by using ***adjustable rate mortgages.*** If money gets tight and interest rates rise, the thrift institutions should be allowed to increase the rate they pay their depositors in order to prevent an outflow of savings. However, in order to pay higher interest on savings accounts, lenders must receive a higher interest rate on their existing loans. With an adjustable rate mortgage, lenders could increase interest rates on their existing loans when they need to increase the interest rate to attract or keep savings accounts. This overcomes the problem referred to as "borrowing short and lending long": Savings and checking deposits constitute loans from depositors to the financial institutions, for which they pay a modest return to the depositor, who usually keeps funds for very short periods; but a home loan to that same depositor would commit the financial institution to a long term, typically 30 years.

LEGISLATION

In 1983 federal legislation set up new regulations replacing those established during the **"**formative**"** years of alternative mortgage instruments. These new regulations allowed more flexibility for both federally chartered banks and savings and loan associations in offering adjustable rate mortgages, or ARMs.

CONSUMER HANDBOOK

The **"Consumer Handbook on Adjustable Rate Mortgages**,**"** prepared by the Federal Reserve Board and Federal Home loan Bank Board, is part of the required disclosures to ARM applicants. Much of the following material is taken from this Consumer Handbook.

The complete copy of the handbook is in Appendix B or

☞ ***You may download the complete copy of the Consumer handbook from www.federalreserve.gov/pubs/brochures/arms/arms.pdf***

CHARACTERISTICS OF ARM

The principal objective of ARMs is to transfer some of the risk of continually rising inflation from the lender to the borrower, while at the same time tailoring loans more closely to the borrower's financial circumstances.

With a fixed–rate mortgage, the interest rate stays the same during the life of the loan. But with an ARM, an adjustable rate mortgage, the interest rate changes periodically, usually in relation to an index, and payments may go up or down accordingly.

LOW INITIAL RATE

Lenders generally charge lower initial interest rates for ARMs than for fixed–rate mortgages. This makes the ARM easier on the pocketbook at first than a fixed–rate mortgage for the same amount. It also means that one might qualify for a larger loan because lenders sometimes make this decision on the basis of current income and the first year's payments. Moreover, an ARM could be less expensive over a long period than a fixed–rate mortgage–for example, if interest rates remain steady or move lower.

- **Teaser rates** – In highly competitive markets, lenders offer so called *teaser* rates. Teaser rates are abnormally tow rates designed to attract borrowers.

  Once the loans are granted, the low teaser rate soon disappears and the usually higher ARM rates take effect. The low teaser rate allows some buyers to qualify for a loan that they would not otherwise be able to obtain. Some lenders are now offering teaser rates but insist that the borrower be able to qualify at the normal or **“**fully indexed**”** ARM rate.

HIGHER FUTURE PAYMENTS

Against these advantages, there is the risk that an increase in interest rates will lead to higher monthly payments in the future. It's a trade–off–a lower initial rate in exchange for assuming more risk. Here are some questions the borrower needs to consider:

- Is my income likely to rise enough to cover higher mortgage payments if interest rates go up?
- Will I be taking on other sizable debts, such as a loan for a car or tuition, in the near future?
- How long do I plan to own this home? (If one plans to sell soon, rising interest rates may not pose the problem they do if one plans to own the house for a long time.)
- Can my payments increase even if interest rates generally do not increase?

HOW DOES AN ARM WORK?

The basic features of any ARM are the adjustment period (frequency of adjustment), the index on which the adjustments are based, and the margin charged by the lender. At the end of each adjustment period, the ARM interest rate for the ensuing period is determined by the formula:

☞ ***ARM Interest Rate = Index Rate + Margin***

Characteristics of ARM Loans

Index

Once the initial interest rate is established, the rate is tied to some *neutral index,* which is one that is beyond the control of the lender or the borrower. A government index, such as the "cost of funds index" of the 11th District of the Federal Home loan Bank of San Francisco, is an example. Some ARMs are tied to certain U.S. Treasury notes. Others are tied to international indexes, such as the London Interbank Offered Rate (LIBOR).

The borrower should know what index will be used, how often it changes, how it has behaved in the past, and where it is published.

Margin

To determine the interest rate on an ARM, lenders add to the index rate a few percentage points called the "margin." The amount of the margin can differ from one lender to another, but it is usually constant over the life of the loan. In comparing ARMs, both the index and margin are important. Some indexes have higher average values, but they are usually used with lower margins.

Adjustment Period

At the present time, with most ARMs, the interest rate and monthly payment change every 6 months. However, some ARMs have different interest and payment changes, and borrower and lender may agree upon any period they choose. The period between one rate change and the next is called the adjustment period. A loan with an adjustment period of 6 months is called a 6–month ARM, and the interest rate can change once every six months.

- Borrowers must be notified at least 30 days prior to a change. After notification, the borrower usually has a 90–day right to pay off the loan without penalty–referred to as the "window period."

PAYMENT CAPS

To avoid what is known as "payment shock," most ARMs have interest **rate caps**–a ceiling on annual and total interest rate increases. A maximum of a 2% per year increase is typical with a 5 to 6% total increase allowed over the initial contract rate. For example, if an ARM starts out at 4%, the maximum increase in any one year might be 2%, with a lifetime maximum of 6% (or a high of 10% for the life of the loan). ARMs must also show the "floor," the lowest rate to which the loan may go, in addition to the ceiling. Sometimes floor rates can go as far down as up.

☞ *Example: Index and Margin*

Suppose one is comparing ARMs offered by two different lenders. Both ARMs are for 30 years, and the loan amount is $65,000. (Note that the payment amounts shown here do not include items like taxes or insurance.)
Both lenders use the one–year Treasury index. But the first lender uses a 2% margin, and the second lender uses a 3% margin. Here is how that difference in margin would affect the initial monthly payment.

Mortgage amount $65,000

First lender	*Second lender*
One–year index 8%	*One–year index = 8%*
Margin =2%	*Margin = 3%*
ARM interest rate = 10%	*ARM interest rate = 11%*
Monthly payment = $570.42	*Monthly payment = $619.01*

☞ *Example: Rate Cap*

At a time when market interest rates might be at 6.5 percent, initial teaser rates could be offered at 4.5 percent, instead of at the then fully–indexed 6.5% rate. The lifetime cap of 5% usually applies to the fully–indexed 6.5% rate, not the 4.5% teaser rate, producing an 11.5% maximum rate for the life of the loan.

DISCOUNTS

Some lenders offer initial ARM rates that are lower than the sum of the index and the margin. Such below–market rates, called discounted rates, are often combined with large initial loan fees ("points") and with higher interest rates after the discount expires.

- **Risk** – All ARMs are to some extent a gamble on the future movement of interest rates, but the risk is compounded by the use of discounts. The borrower must decide in each particular situation if the initial advantage is worth the risk.

- **Seller Buydown** – Very large discounts are often arranged by the seller. The seller pays an amount to the lender so the lender can offer a lower rate and lower payments early in the mortgage term. This arrangement is referred to as a "seller buydown." The seller may increase the sales price of the home to cover the cost of the buydown.

- **Other buydown** – Borrowers may also be able to negotiate buydowns of the terms of ARMs.

- **Qualifying** – A lender may use a low initial rate to decide whether to approve a loan, based on the borrower's ability to make payments. Borrowers must seriously consider whether they will be able to afford payments in later years when the discount expires and the rate is adjusted.

- **Future Payment Shock** – With a discounted ARM, the low initial payment will probably not remain low for long, and any saving during the discounted period will normally be made up during the life of the mortgage or be included in the price of the house. "Payment shock" may occur if the mortgage payment rises sharply at the first adjustment.

☞*Example: Discounts*

Here is how a discount might work. Let's assume the one–year ARM rate (index rate plus margin) is at 10%. But the lender is offering an 8% rate for the first year. with the 8% rate, the first–year monthly payment would be $476.95.

Let's see what happens in the second year with the discounted 10% ARM.

ARM Interest Rate	*Monthly Payment*
First year (with discount) 8%	*$476.95*
2nd year at 10%	*$568.82*

As the example shows, even if the index rate stays the same, the monthly payment goes up from $476.95 to $568.82 in the second year.

Suppose that the index rate increases 2% in one year and the ARM rate rises to a level of 12%.

ARM Interest Rate	*Monthly Payment*
First year (with discount) 8%	*$476.95*
2nd year at 12%	*$665.43*

That's an increase of almost $200 in monthly payment.

NEGATIVE AMORTIZATION AND ADJUSTABLE RATE MORTGAGES

Negative amortization can arise during times of high inflation. Rapid inflation creates a need to qualify a borrower at a low entry level rate of interest even though the payments will later increase to accommodate full amortization of the loan over a particular term of years.

In some cases, the initial monthly payments may be inadequate to cover the interest, let alone provide for any principal reduction. Whatever the amount of the interest shortfall, it is added to the existing principal balance of the loan, and the following month, the process is repeated. Since the interest shortfall is always added to the principal balance existing at the time, the borrower ends up paying interest on interest, and the principal balance grows with compounding effect.

☞ ***Example:***

You borrow $100,000 at 9% with payments of $600 per month. The first month's interest should be $100,000 X 9% = $9,000 divided by 12 months = $750 per month to cover the interest. But since you pay only $600, you are short $150 on the interest portion. This $150 is added to the existing loan amount of $100,000, resulting in a new balance of $100,150 after the first month's payment of $600. The second month's calculation would be $100,150 X 9% = $9,013.50 divided by 12 months = $751.13, less the second payment of $600 = $151.13 shortage. This $151.13 shortage would be added to the previous balance of $100,150 to bring the new balance to $100,301.13 and the process would continue with each subsequent monthly payment of $600. As you can see, the negative amortization just continues to increase the size of the loan balance due.

Some of the original ARMs contained provisions by which the negative amortization on an 80% LTV loan could produce a loan balance equal to 125% of the original debt. When the loan reached this point, it was obviously equal to the value of the security property, and the note then required that the loan be automatically recast, with the introduction of new monthly payments scheduled to fully amortize the loan over the remaining term. The result was that many owners lost their homes through foreclosure; loan provisions had to, and did, change.

It is important to note that two changes can take place in connection with an ARM: a change in the interest rate and a change in the monthly payment. One can occur without the other. If changes in the payments are not made concurrently to accommodate the higher interest rates, negative amortization can take place, resulting in a debt increase rather than a decrease. There has been a definite movement by lenders away from granting real estate loans with negative amortization.

ADVANTAGES OF ARM

Adjustable rate mortgages and similar instruments have advantages in periods of rapidly changing market conditions.

- ARMs allow the market rather than the government to regulate interest rate fluctuations.
- They give the lender mortgage loan incentives, by maintaining an interest rate commensurate with lender's cost of funds. Institutional lenders tend to be wary of long–term, fixed–rate loans during periods of fight money, high interest rates, inflation, recession, or stagflation.
- Lower initial rates when compared with fixed rates.
- Easier qualifying for home purchases in many cases.
- Initial costs of the loan are usually smaller.
- Ability to qualify for a larger loan at the lower interest rate.
- ARMs respond to the needs of housing demand (borrower's needs), by providing for lower payments in the early years of the loan, or by offering assurance that a temporarily high market interest rate will not prevail for the entire life of the loan. In some cases, the lower rate can mean a larger loan and a larger house.
- Generally easier assumability upon resale.

- No prepayment penalties.

DISADVANTAGES OF ARM

- Income may not increase proportionately with increases in payments.
- In a slow real estate market, the rate of appreciation may be less than the rate of increase in the interest rates; that is, the spread between the value of the property and the outstanding loan balance could shrink each year, rather than increase.
- In some cases, the prospect for negative amortization means that borrowers may owe more than they would net out of the resale proceeds if the property is sold in the early years.
- The risk of rising interest rates is borne partly by the borrower, since the risk of change in the cost of funds can be shifted entirely to the borrower, within maximum caps allowed over the life of the loan.

CALIFORNIA ADJUSTABLE–RATE NOTE

The notes that will be reviewed in this section are those issued by Fannie Mae/FHLMC as of January 2001, with four notes in the series. All of these notes will use U.S. Treasury Securities as an index.

ADJUSTABLE–RATE NOTE (1 YEAR TREASURY INDEX RATE CAPS)

This note is shown in Form 9–1. The top of the first page of the note states in bold type that the note contains provisions that allow the interest rate and monthly payment to change. This note limits the amount the interest may change at any adjustment or change date and states the maximum interest rate the borrower will pay.

Section 1 is identical to the fixed–rate note. It states that the borrower promises to pay to the lender an amount with interest.

Section 2 states that the interest will be charged on the unpaid balance and at a yearly rate of _____ percent, as well as stating that the interest rate will change in accordance with Section 4 of the note.

Section 3 is divided into three subsections. Subsection A, Time and Place of Payments, is identical to the California fixed–rate note. Subsections B and C are unique to this note. Subsection B, Amount of My Initial Monthly Payments, will state the payment in dollars. Because this is an adjust–able–rate note and is adjusted every year, Subsection C states that the interest rate and payment will change.

In Subsection A of Section 4, Interest Rate and Monthly Payment Changes, the change date is established for the first change and as the subsection states, the interest rate will change on that day every year thereafter.

Subsection B establishes the interest–rate index that will be used. For the note and all of the Fannie Mae/FHLMC California adjustable–rate notes, the index will be either the 1–, 3–, or 5–year Treasury securities. Because this note will be adjusted annually, the 1–year Treasury security will be used as the index for this note. As you will notice, the note is Specific. The index will be the weekly average yield of the 1–year Treasury security. As we learned in our study of the ARM disclosures, the lender must identify what will be used as the current index. This information is also contained in this subsection.

In subsection C, Calculation of Changes, you will note that the lender will calculate the new interest rate by adding a certain spread or margin to the current index. In addition, this subsection allows the lender to round the interest rate to the nearest one–eighth. Using the new interest rate and the remaining term, the lender will calculate the new monthly payment that would be required to pay the loan off over the remaining term. Subsections D, E, and F deal with limiting the increase in the interest rate. Subsection D limits the interest rate increase or decrease to no more than 1 percent in any 12–month period. In addition to limiting the amount of increase per adjustment date, the note states the interest rate the borrower will pay will not be greater than _____ percent or less than _____ percent. This percentage will not be more than the initial interest rate plus the margin of 5 percent.

Subsection E establishes the effective date of changes, and Subsection F states the time, method, and content of the rate and payment change notice the lender must give to the borrower.

Section 5, Borrower's Right to Prepay, is similar to the fixed–rate note explained earlier.

Section 7, Borrower's Failure to Pay as Required, gives the lender the right to impose a late charge if the payment is not received usually by the 15th of the month. In addition, it states that if the borrower does not pay on the date the payment is due, he or she will be in default and, if the borrower does go into default, the lender may send a notice that the borrower is in default. Finally, in this section the borrower agrees to pay the lender for his or her costs in enforcing the note.

The remainder of the note is very similar to the fixed rate note and is self–explanatory.

Form 9-1: Adjustable Rate Note (4 pages)

ADJUSTABLE RATE NOTE
(1 Year Treasury Index - Rate Caps)

THIS NOTE CONTAINS PROVISIONS ALLOWING FOR CHANGES IN MY INTEREST RATE AND MY MONTHLY PAYMENT. THIS NOTE LIMITS THE AMOUNT MY INTEREST RATE CAN CHANGE AT ANY ONE TIME AND THE MAXIMUM RATE I MUST PAY.

____________________, ________ ____________________________, ____________________________

[Date] [City] [State]

____

[Property Address]

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $ ________________________ (this amount is called "Principal"), plus interest, to the order of the Lender. The Lender is __________________________________ __________________________. I will make all payments under this Note in the form of cash, check or money order.

I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder."

2. INTEREST

Interest will be charged on unpaid principal until the full amount of Principal has been paid. I will pay interest at a yearly rate of _________%. The interest rate I will pay will change in accordance with Section 4 of this Note.

The interest rate required by this Section 2 and Section 4 of this Note is the rate I will pay both before and after any default described in Section 7(B) of this Note.

3. PAYMENTS

(A) Time and Place of Payments

I will pay principal and interest by making a payment every month.

I will make my monthly payment on the first day of each month beginning on __________________________, _________. I will make these payments every month until I have paid all of the principal and interest and any other charges described below that I may owe under this Note. Each monthly payment will be applied as of its scheduled due date and will be applied to interest before Principal. If, on __________________________, 20____, I still owe amounts under this Note, I will pay those amounts in full on that date, which is called the "Maturity Date."

I will make my monthly payments at ____ ____ or at a different place if required by the Note Holder.

(B) Amount of My Initial Monthly Payments

Each of my initial monthly payments will be in the amount of U.S. $____________________________. This amount may change.

(C) Monthly Payment Changes

Changes in my monthly payment will reflect changes in the unpaid principal of my loan and in the interest rate that I must pay. The Note Holder will determine my new interest rate and the changed amount of my monthly payment in accordance with Section 4 of this Note.

4. INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Change Dates

The interest rate I will pay may change on the first day of ____________________________, _______, and on that day every 12th month thereafter. Each date on which my interest rate could change is called a "Change Date."

MULTISTATE ADJUSTABLE RATE NOTE-ARM 5-1--Single Family--Fannie Mae/Freddie Mac UNIFORM INSTRUMENT Form 3501 1/01 *(page 1 of 4 pages)*

(B) The Index

Beginning with the first Change Date, my interest rate will be based on an Index. The "Index" is the weekly average yield on United States Treasury securities adjusted to a constant maturity of one year, as made available by the Federal Reserve Board. The most recent Index figure available as of the date 45 days before each Change Date is called the "Current Index."

If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me notice of this choice.

(C) Calculation of Changes

Before each Change Date, the Note Holder will calculate my new interest rate by adding _______________ percentage points (____________%) to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date.

The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the Maturity Date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

(D) Limits on Interest Rate Changes

The interest rate I am required to pay at the first Change Date will not be greater than ____________% or less than ________________%. Thereafter, my interest rate will never be increased or decreased on any single Change Date by more than one percentage point (1.0%) from the rate of interest I have been paying for the preceding 12 months. My interest rate will never be greater than ___________%.

(E) Effective Date of Changes

My new interest rate will become effective on each Change Date. I will pay the amount of my new monthly payment beginning on the first monthly payment date after the Change Date until the amount of my monthly payment changes again.

(F) Notice of Changes

The Note Holder will deliver or mail to me a notice of any changes in my interest rate and the amount of my monthly payment before the effective date of any change. The notice will include information required by law to be given to me and also the title and telephone number of a person who will answer any question I may have regarding the notice.

5. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a "Prepayment." When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate a payment as a Prepayment if I have not made all the monthly payments due under the Note.

I may make a full Prepayment or partial Prepayments without paying a Prepayment charge. The Note Holder will use my Prepayments to reduce the amount of Principal that I owe under this Note. However, the Note Holder may apply my Prepayment to the accrued and unpaid interest on the Prepayment amount, before applying my Prepayment to reduce the Principal amount of the Note. If I make a partial Prepayment, there will be no changes in the due dates of my monthly payment unless the Note Holder agrees in writing to those changes. My partial Prepayment may reduce the amount of my monthly payments after the first Change Date following my partial Prepayment. However, any reduction due to my partial Prepayment may be offset by an interest rate increase.

6. LOAN CHARGES

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the Principal I owe under this Note or by making a direct payment to me. If a refund reduces Principal, the reduction will be treated as a partial Prepayment.

7. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charges for Overdue Payments

If the Note Holder has not received the full amount of any monthly payment by the end of ________ calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be ___________% of my overdue payment of principal and interest. I will pay this late charge promptly but only once on each late payment.

(B) Default

If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.

(C) Notice of Default

If I am in default, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date, the Note Holder may require me to pay immediately the full amount of Principal which has not been paid and all the interest that I owe on that amount. That date must be at least 30 days after the date on which the notice is mailed to me or delivered by other means.

(D) No Waiver By Note Holder

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(E) Payment of Note Holder's Costs and Expenses

If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees.

8. GIVING OF NOTICES

Unless applicable law requires a different method, any notice that must be given to me under this Note will be given by delivering it or by mailing it by first class mail to me at the Property Address above or at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by delivering it or by mailing it by first class mail to the Note Holder at the address stated in Section 3(A) above or at a different address if I am given a notice of that different address.

9. OBLIGATIONS OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each person is fully and personally obligated to keep all of the promises made in this Note, including the promise to pay the full amount owed. Any person who is a guarantor, surety or endorser of this Note is also obligated to do these things. Any person who takes over these obligations, including the obligations of a guarantor, surety or endorser of this Note, is also obligated to keep all of the promises made in this Note. The Note Holder may enforce its rights under this Note against each person individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note.

10. WAIVERS

I and any other person who has obligations under this Note waive the rights of Presentment and Notice of Dishonor. "Presentment" means the right to require the Note Holder to demand payment of amounts due. "Notice of Dishonor" means the right to require the Note Holder to give notice to other persons that amounts due have not been paid.

11. UNIFORM SECURED NOTE

This Note is a uniform instrument with limited variations in some jurisdictions. In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust, or Security Deed (the "Security Instrument"), dated the same date as this Note, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note. That Security Instrument describes how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note. Some of those conditions are described as follows:

If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law. Lender also shall not exercise this option if: (a) Borrower causes to be submitted to Lender information required by Lender to evaluate the intended transferee as if a new loan were being made to the transferee; and (b) Lender reasonably determines that Lender's security will not be impaired by the loan assumption and that the risk of a breach of any covenant or agreement in this Security Instrument is acceptable to Lender.

To the extent permitted by Applicable Law, Lender may charge a reasonable fee as a condition to Lender's consent to the loan assumption. Lender may also require the transferee to sign an assumption agreement that is acceptable to Lender and that obligates the transferee to keep all the promises and agreements made in the Note and in this Security Instrument. Borrower will continue to be obligated under the Note and this Security Instrument unless Lender releases Borrower in writing.

If Lender exercises the option to require immediate payment in full, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

WITNESS THE HAND(S) AND SEAL(S) OF THE UNDERSIGNED.

_______________________________________(Seal)
- Borrower

_______________________________________(Seal)
- Borrower

_______________________________________(Seal)
- Borrower

[Sign Original Only]

HOW CAN THE BORROWER REDUCE THE RISK?

Choosing an ARM solely because of its low initial rate can be risky. Borrowers can look for mortgages with features designed to reduce such risks. Many ARMs have "caps" that protect borrowers from extreme increases in interest rates or monthly payments. Others allow borrowers to convert an ARM to a fixed–rate mortgage. However, these features may cost more or add risks of their own, such as negative amortization.

- **Interest–Rate Caps** – An interest–rate cap places a limit on the amount the interest rate can increase. A cap is like insurance, so ARMs with caps may cost more than ARMs without them. Interest caps are of two types: periodic caps limit the interest–rate increase from one adjustment period to the next; overall caps limit the interest–rate increase over the life of the loan. An ARM may have both a periodic and an overall interest–rate cap.

☞*Example: Periodic Cap*

Consider an ARM with a periodic interest–rate cap of 2%. At the first adjustment, the index rate goes up 3%. The example shows what happens.

ARM Interest Rate	*Monthly Payment*
First year at 10%	*$570.42*
2nd year at 13% (without cap)	*$717.12*
2nd year at 12% (with cap)	*$667.30*

Difference in second year between payment with the cap and payment without the cap = $49.82

- **Deferred Increase** – A drop in interest rates does not always lead to a drop in monthly payments. In fact, with some ARMs that have interest rate caps, the payment amount may increase at a given adjustment period even though the index rate has stayed the same or declined. This may happen after an interest rate cap has been holding the interest rate down below the sum of the index plus margin.

☞*Example: Increase Deferred by Periodic Cap*

In this example there is a periodic cap of 2% on the ARM, and the index went up 3% at the first adjustment. If the index stays the same in the third year, the rate will go up to 13%, making up the 1% not added the previous year.

ARM Interest Rate	*Monthly Payment*
First year at 10%	*$570.42*
If index rises 3%, 2nd year at 12% (with 2% rate cap)	*$667.30*
If the index stays the same, 3rd year at 13%	*$716.56*

Even though index stays the same, payment goes up $49.26

In general, the rate on the loan can go up at any scheduled adjustment when the index plus the margin is higher than the rate before that adjustment.

- **Overall Cap** – An ARM may also have an overall interest rate cap. The next example shows the effects of a 5% overall rate cap. Suppose the index rate increases 1% in each of the first ten years:

☞*Example: Overall Cap*

ARM Interest Rate	*Monthly Payment*
First year at 10%	*$570.42*
10th year at 19% (without a cap)	*$1,008.64*
10th year at 14% (with a cap)	*$764.08*

with a 5% overall rate cap, the monthly payment would never exceed $764.08, no matter how much rates continue to rise.

- **Payment Caps** – Some ARMs include payment caps, which limit the monthly payment increase at the time of each adjustment, usually to a percentage of the previous payment. In other words, with a 7+% payment cap, a payment of $100 could increase to no more than $107.50 in the first adjustment period, and to no more than $115.56 in the second.

☞*Example: Payment Caps*

Assume that the rate changes in the first year by 2 percentage points, but payments can increase by no more than 7½% in any one year.
Here is how the monthly payments would be affected:

ARM Interest Rate	*Monthly Payment*
First year at 10%	*$570.42*
2nd year at 12% (without payment cap)	*$667.30*
2nd year at 12% (with 7½% payment cap)	*$613.20*
Difference in monthly payment =	*$54.10*

Many ARMS with payment caps do not have periodic interest rate caps.

Negative Amortization

Because payment caps limit only payment increases, and not interest rate increases, payments held down by a cap may not cover all of the interest due on the loan. **"**Negative amortization**"** may occur if an ARM contains a payment cap. Negative amortization means the mortgage balance is increasing because monthly mortgage payments are not large enough to pay all of the interest due on the mortgage.

- **Increased Debt** – The interest shortage in each payment is automatically added to the debt, and interest may be charged on that amount. The borrower might, therefore, owe the lender more later in the loan term than at the start. However, an increase in the value of the home may make up for the increase in what is owed, so an ARM with negative amortization may still be an acceptable risk.

☞ *Example: Negative Amortization*

Using the figures from the preceding example, here is how negative amortization works during one year. The first 12 payments of $570.42, based on a 10% interest rate, paid the balance down to $64,638.72 at the end of the first year. The rate goes up to 12% in the second year. But because of the 72% payment cap, payments are not high enough to cover all the interest. The interest shortage is added to the debt (with interest on it), which produces negative amortization of $420.90 during the second year.

Beginning loan amount = $65,000
Loan amount at end of first year $64,638.72
Negative amortization during 2nd year = $420.90
Loan amount at end of 2nd year = $65,059.82 ($64,638.72 + $420.90)

If the house is sold at this point, the owner would owe almost $60 more than the amount originally borrowed.

- **Increased Payments** – The payment cap limits increases in monthly payment by deferring some of the increase in interest. Eventually, the borrower will have to repay the higher remaining loan balance, at the ARM rate then in effect. When this happens, there may be a substantial increase in the monthly payment.

- **Negative Amortization Caps** – Some mortgages contain a cap on negative amortization. The cap typically limits the total amount one can owe to 125% of the original loan amount. When that point is reached, monthly payments may be set to fully repay the loan over the remaining term, and the payment cap may not apply. A borrower may limit negative amortization by voluntarily increasing the monthly payment.

- **Prepayment** – Many ARMs allow the borrower to pay the loan in full or in part without penalty whenever the rate is adjusted. Some agreements may require special fees or penalties in order to pay off the ARM early. Prepayment details are sometimes negotiable. If so, the borrower may want to negotiate for no penalty, or for as low a penalty as possible.

- **Conversion** – If a buyer gets an ARM and the financial circumstances change, the borrower may decide not to risk any further changes in the interest rate and payment amount. The agreement with the lender can have a clause that lets the borrower convert the ARM to a fixed–rate mortgage at designated times. The converted rate is generally set at the current market rate for fixed–rate mortgages. In exchange for this flexibility, the interest rate or up–front fees may be higher for a convertible ARM, and there may be a special fee at the time of conversion.

ARM DISCLOSURES (REGULATION Z)

The 1988 Regulation Z amendments are the first disclosures specifically designed for the increasingly popular variable–rate instruments. Before the amendments, only the standard Truth in lending disclosures were made, and they came late in the financing process (when actual costs were fully known) and could not accurately reflect the effects of variable terms.

The new disclosures, using a $10,000 model loan example and a historical summary of the index being used, are able to give the borrower a clear picture of how payments and loan balance may be affected by a variable interest rate. The essential features of an ARM are specifically addressed in these disclosures: the index used, how interest rate and payment are determined, frequency of adjustment, caps, and the possibility of negative amortization.

REQUIREMENTS

The Regulation Z amendments require creditors to distribute to consumers an educational booklet about adjustable rate mortgages, and to provide a detailed description of the variable rate feature, along with a historical example.

- **Application** – The amendments apply only to closed–end credit transactions secured by the consumer's principal dwelling, including both purchase money and non–purchase money, for terms of more than one year.
- **Timing** – The information must be provided
    - At the time an application form is given to the consumer or
    - Before the consumer pays a non–refundable fee, whichever is earlier.
- Disclosure at this time is possible under the amendments because the new rule requires that disclosure reflect ARM loan program features, but not the terms of individual transactions.

- **Two Disclosures** – Under the new rule, the variable–rate disclosures are given to consumers earlier than the standard Truth in lending information. The later Truth in lending disclosures must include a statement that an adjustable–rate feature exists and that the variable–rate disclosures have been provided to the consumer.

DISCLOSURE CONTENTS

- **Educational Booklet** –The Federal Reserve's Consumer Handbook on Adjustable Rate Mortgages or another booklet containing comparable information must be provided by the lender to a prospective borrower at the time an application form is given to the consumer or before the consumer pays a non–refundable fee, whichever is earlier.

- **ARM Features** – Creditors are required to specify the following:

  - The index to which interest rate changes are tied
  - A source of information about the index
  - An explanation of how the interest rate and payment will be determined, for example, a statement that the interest rate will be based on a specified index plus a margin and that the payment will be based on the interest rate, the loan balance, and the remaining loan term
  - A statement that will alert consumers about a discount feature when the initial rate is discounted
  - The frequency of rate and payment adjustments
  - If the presence of rate or payment caps can result in negative amortization, a statement about those features
  - The existence of a demand feature, if applicable
  - A statement describing the type of information that will be contained in an adjustment notice
  - When adjustment notices will be provided.

- Negative amortization features, if any.
- Maximum caps on (1) the amount interest increase and (2) the total for the loan.

The lender may comply with Regulation Z by giving the potential borrower the ***Consumer Handbook on Adjustable Rate Mortgages*** *(appendix B),* published by the Federal Reserve and the Federal Home loan Bank Board. In addition, California lenders are required to have the borrower sign an adjustable rate loan rider to the promissory note.

Subsequent Disclosures

Each adjustment to the interest rate in a variable–rate transaction, with or without a corresponding adjustment to the payment, is an event requiring new disclosures to the consumer.

- **Timing** – Disclosures are required at least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25, but not more than 120, calendar days before a payment at a new level is due.
- **Disclosure Contents** – The following disclosures, as applicable, must he delivered or placed in the mail:
  - The current and prior interest rates
  - The applicable index values
  - The contractual effects of the adjustment, including the payment due after the adjustment, and a statement of the loan balance
  - The payment (if different from above) that would fully amortize the loan at the new interest rate over the remaining loan term.
- **Adjustment Period Notice** – Notice is required whenever interest rate adjustments and corresponding payment adjustments can be made periodically under the loan agreement, even if they are not made because, for example, the index values have not changed or an interest rate cap has prevented any adjustments.

- **Other Agency Disclosures** – Information provided in accordance with variable rate subsequent disclosure regulations of other federal agencies may be substituted for the disclosures required by Regulation Z.

CONVERTIBLE MORTGAGE

There are times when prospective borrowers are torn between the initial low payments of the adjustable rate loan with the possibility of large increases in future payments, and a ***fixed rate loan*** with the initial higher, but certain, monthly payment. The ARM is low now but could increase to more than the present fixed rate loan. Borrowers ask themselves, Do I go adjustable or fixed? One answer may be a ***convertible rate loan.***

A convertible rate loan is a hybrid that typically starts as an adjustable rate loan but contains the option to switch to a fixed rate loan at some later date. Or it may be the reverse: the loan starts as a fixed rate and later can be switched to an ARM. For this privilege, borrowers usually pay slightly higher initial rates than for conventional (i.e., nonconvertible) ARMs. There are many varieties of convertible rate loans. A borrower needs to ask, When can I convert? How much will it cost? Do I get the prevailing fixed interest rate or a higher–than–market fixed rate? let's look at each, ARM to Fixed and Fixed to ARM, to answer some of these questions.

ARM TO FIXED CONVERSION

This type of ARM was developed to counteract many borrowers fears of the uncertainty of future increases in the interest rate on their mortgages.

With this type of ARM, the borrower is given the option to convert to a fixed–term, fixed–rate mortgage. This conversion may be a one–time option or the lender may offer the borrower an option to convert on any adjustment date. This conversion is normally offered on the 1–, 3–, or 5–year ARMs. Thus, if the borrower has a 3–year ARM with a conversion option at the first adjustment date the borrower could opt to convert to a fixed rate fixed–term 27–year mortgage at the first adjustment date. lithe convertible ARM gave the option of conversion at any adjustment date and the borrower opts to convert on the second adjustment date, then the borrower would have a fixed rate, fixed–term 24–year mortgage.

Why would a borrower opt to convert? The borrower might opt to convert if the interest rate, at the time of adjustment had fallen to a level at which the borrower felt he or she could make the payments. For example, if a borrower had received an ARM in August 1999 when the rates on the 3 and 5–year ARMs were in the 9 to 10 percent range, then at the first adjustment date, When the rate on a fixed–term, fixed–rate mortgage had fallen to 8 percent, a conversion may have been a good option. The advantage of this conversion over time is a function of the level of interest rates.

As with any type of loan, the convertible ARM will require the borrower to sign a note and deed of trust, but because this is not a standard ARM the lender may have to require the borrower and/or borrower to sign some additional documents. A lender has two options. One is to use one of the standard ARM notes, note addendum, and deed of trust addendum to the ARM deed of trust rider. If a lender uses these documents, two additional documents will have to be signed by the borrower and/or co–borrower, an Addendum To Adjustable Rate/Graduated Payment Note (Fixed Rate Conversion Option), and Addendum To Adjustable Rate /Graduated Payment Rider (Fixed Rate Conversion Option), (FNMA Form 3130 as illustrated in Form 9–2). These are to be used with an ARM based on a 1 –year Treasury index, but the same documents are available for use with an ARM based on a 3 – or 5–year Treasury index.

As the title indicates, these documents may also be used with a graduated payment mortgage, thus allowing the borrower to convert the GPM to a fixed–rate mortgage. These documents outline the steps to be followed to convert an ARM or GPM to a fixed–rate mortgage, as well as how the fixed rate of interest will be calculated.

The other option available to the lender is the use of an FHLMC convertible ARM note. This note is similar to the ARM notes reviewed in the previous section. There is one major difference: paragraph 5, Conversion to Fixed Interest Rate. Section A indicates on which change date the borrower will be allowed to convert. This could be the first or the first, second, and third or any change dates specified in this section. Section B states how the fixed rate will be established. Finally, in Section C, borrowers are advised that, if they should convert, they will have to sign a document as evidence of the modification of the note.

Form 9-1: Adjustable Rate Rider (Conversion Option)

ADJUSTABLE RATE RIDER
(1 Year Treasury Index - Rate Caps - Fixed Rate Conversion Option)

THIS ADJUSTABLE RATE RIDER is made this ______ day of ________________________________, ________, and is incorporated into and shall be deemed to amend and supplement the Mortgage, Deed of Trust, or Security Deed (the "Security Instrument") of the same date given by the undersigned (the "Borrower") to secure Borrower's Adjustable Rate Note (the "Note") to ____ ____ (the "Lender") of the same date and covering the property described in the Security Instrument and located at:

____

[Property Address]

THE NOTE CONTAINS PROVISIONS ALLOWING FOR CHANGES IN THE INTEREST RATE AND THE MONTHLY PAYMENT. THE NOTE LIMITS THE AMOUNT THE BORROWER'S ADJUSTABLE INTEREST RATE CAN CHANGE AT ANY ONE TIME AND THE MAXIMUM RATE THE BORROWER MUST PAY. THE NOTE ALSO CONTAINS THE OPTION TO CONVERT THE ADJUSTABLE RATE TO A FIXED RATE.

ADDITIONAL COVENANTS. In addition to the covenants and agreements made in the Security Instrument, Borrower and Lender further covenant and agree as follows:

A. ADJUSTABLE RATE AND MONTHLY PAYMENT CHANGES

The Note provides for an initial interest rate of __________________%. The Note provides for changes in the adjustable interest rate and the monthly payments, as follows:

4. ADJUSTABLE INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Change Dates

The adjustable interest rate I will pay may change on the first day of ______________________________, ______, and on that day every 12th month thereafter. Each date on which my adjustable interest rate could change is called a "Change Date."

(B) The Index

Beginning with the first Change Date, my adjustable interest rate will be based on an Index. The "Index" is the weekly average yield on United States Treasury securities adjusted to a constant maturity of one year, as made available by the Federal Reserve Board. The most recent Index figure available as of the date 45 days before each Change Date is called the "Current Index."

If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me notice of this choice.

(C) Calculation of Changes

Before each Change Date, the Note Holder will calculate my new interest rate by adding ______________ ________________ percentage points (________________%) to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date.

The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the maturity date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

(D) Limits on Interest Rate Changes

The interest rate I am required to pay at the first Change Date will not be greater than ____________% or less than ______________%. Thereafter, my interest rate will never be increased or decreased on any single Change Date by more than _____________ percentage points (_______%) from the rate of interest I have been paying for the preceding 12 months. My interest rate will never be greater than ___________%, which is called the "Maximum Rate."

(E) Effective Date of Changes

My new interest rate will become effective on each Change Date. I will pay the amount of my new monthly payment beginning on the first monthly payment date after the Change Date until the amount of my monthly payment changes again.

(F) Notice of Changes

The Note Holder will deliver or mail to me a notice of any changes in my adjustable interest rate and the amount of my monthly payment before the effective date of any change. The notice will include information required by law to be given to me and also the title and telephone number of a person who will answer any question I may have regarding the notice.

B. FIXED INTEREST RATE OPTION

The Note provides for the Borrower's option to convert from an adjustable interest rate with interest rate limits to a fixed interest rate, as follows:

5. FIXED INTEREST RATE CONVERSION OPTION

(A) Option to Convert to Fixed Rate

I have a Conversion Option which I can exercise unless I am in default or this Section 5(A) will not permit me to do so. The "Conversion Option" is my option to convert the interest rate I am required to pay by this Note from an adjustable rate with interest rate limits to the fixed rate calculated under Section 5(B) below.

The conversion can only take place on a date(s) specified by the Note Holder during the period beginning on the first Change Date and ending on the fifth Change Date. Each date on which my adjustable interest rate can convert to the new fixed rate is called the "Conversion Date."

If I want to exercise the Conversion Option, I must first meet certain conditions. Those conditions are that: (i) I must give the Note Holder notice that I want to do so; (ii) on the Conversion Date, I must not be in default under the Note or the Security Instrument; (iii) by a date specified by the Note Holder, I must pay the Note Holder a conversion fee of U.S. $________________________________; and (iv) I must sign and give the Note Holder any documents the Note Holder requires to effect the conversion.

(B) Calculation of Fixed Rate

My new, fixed interest rate will be equal to the Federal Home Loan Mortgage Corporation's required net yield as of a date and time of day specified by the Note Holder for (i) if the original term of this Note is greater than 15 years, 30-year fixed rate mortgages covered by applicable 60-day mandatory delivery commitments, plus three-eighths of one percentage point (0.375%), or (ii) if the original term of this Note is 15 years or less, 15-year fixed rate mortgages covered by applicable 60-day mandatory delivery commitments, plus three-eighths of one percentage point (0.375%). If this required net yield cannot be determined because the applicable commitments are not available, the Note Holder will determine my interest rate by using comparable information. My new rate calculated under this Section 5(B) will not be greater than the Maximum Rate stated in Section 4(D) above.

(C) New Payment Amount and Effective Date

If I choose to exercise the Conversion Option, the Note Holder will determine the amount of the monthly payment that would be sufficient to repay the unpaid principal I am expected to owe on the Conversion Date in full on the maturity date at my new fixed interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment. Beginning with my first monthly payment after the Conversion Date, I will pay the new amount as my monthly payment until the maturity date.

C. TRANSFER OF THE PROPERTY OR A BENEFICIAL INTEREST IN BORROWER

1. UNTIL BORROWER EXERCISES THE CONVERSION OPTION UNDER THE CONDITIONS STATED IN SECTION B OF THIS ADJUSTABLE RATE RIDER, UNIFORM COVENANT 18 OF THE SECURITY INSTRUMENT IS AMENDED TO READ AS FOLLOWS:

Transfer of the Property or a Beneficial Interest in Borrower. As used in this Section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.

If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law. Lender also shall not exercise this option if: (a) Borrower causes to be submitted to Lender information required by Lender to evaluate the intended transferee as if a new loan were being made to the transferee; and (b) Lender reasonably determines that Lender's security will not be impaired by the loan assumption and that the risk of a breach of any covenant or agreement in this Security Instrument is acceptable to Lender.

To the extent permitted by Applicable Law, Lender may charge a reasonable fee as a condition to Lender's consent to the loan assumption. Lender may also require the transferee to sign an assumption agreement that is acceptable to Lender and that obligates the transferee to keep all the promises and agreements made in the Note and in this Security Instrument. Borrower will continue to be obligated under the Note and this Security Instrument unless Lender releases Borrower in writing.

If Lender exercises the option to require immediate payment in full, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

2. IF BORROWER EXERCISES THE CONVERSION OPTION UNDER THE CONDITIONS STATED IN SECTION B OF THIS ADJUSTABLE RATE RIDER, THE AMENDMENT TO UNIFORM COVENANT 18 OF THE SECURITY INSTRUMENT CONTAINED IN SECTION C1 ABOVE SHALL THEN CEASE TO BE IN EFFECT, AND THE PROVISIONS OF UNIFORM COVENANT 18 OF THE SECURITY INSTRUMENT SHALL INSTEAD BE IN EFFECT, AS FOLLOWS:

Transfer of the Property or a Beneficial Interest in Borrower. As used in this Section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.

If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.

If Lender exercises this option, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

BY SIGNING BELOW, Borrower accepts and agrees to the terms and covenants contained in this Adjustable Rate Rider.

____(Seal)
- Borrower

____(Seal)
- Borrower

FIXED TO ARM CONVERSIONS

A wide variety of ARM loans are offered with fixed to ARM convertible features. They may come with labels like 1/1 ARM, 3/1 ARM, 5/1 ARM, 7/1 ARM, 10/1 ARM, and so on. The first number represents the number of years the rate is fixed, and the second designates how often the rate may adjust there after. For the 5/1 ARM, for instance, the rate is fixed for five years, and then converts to a one–year ARM, usually adjustable thereafter each year for the life of the loan. In general, the larger the first number (that is, the larger the fixed rate term), the higher the interest rate. For example, lenders may quote 6% interest for a 1/1, 6.5% for a 3/1, and 7% for a 5/1 ARM, with one discount point for each.

OTHER AMI/CREATIVE FINANCING ALTERNATIVES

Non–traditional forms of financing can be examined in several other categories: those where the seller assists by lending, cooperating in the assumption of a loan, or other ways; those where a lender provides concessions in exchange for a future benefit; etc.

JUNIOR TRUST DEED (SECONDARY TD'S)

A "**junior trust deed**" or a "***junior lien***" or secondary financing mortgage, is any trust deed or mortgage that is not a first trust deed.

A junior loan is any claim subordinate to (junior to) another claim against the security; it is a claim whose priority is after the first trust deed or mortgage.

When the current financial market is tight, or when a buyer does not have enough cash to cover between the sale price and the loan amount, another loan or "second" trust deed is sometimes obtained (often from the seller).

- Priority is established by time of recording. The risk of a junior lienholder is higher; lenders therefore usually demand a higher interest rate.
- The beneficiary of a junior loan should record a request for notice of default so that he or she will be protected if the borrower defaults on a prior loan.
- The basic protection for the lender is the borrower's equity.

- Private lenders are the greatest source of junior loans.
- A second TD holder, just like the first TD holder, can start default action if the trustor defaults on the second.
- If the trustor defaults on the first TD, the second TD holder can reinstate the first TD and start default action against the trustor. If the property's value is higher than the total amount owed on the first TD, it is a wise move for the second TD holder to start his or her own default and sale action.
- **Source of Funds** - Private individuals were for a long time the primary source of funds for junior loans, but financial deregulation of the Institutional lenders, combined with income tax law changes, have led to extensive marketing of junior loans by banks and savings and loan associations.

EQUITY LOANS

The loans generally marketed as "equity loans" are junior loans (second mortgages) of certain amounts, usually at adjustable interest rates, usually amortized over fixed periods of time, such as 15 or 20 years, and secured by the borrower's equity in the property. They may even be insured by FHA Title I if the money is borrowed for home improvements. Except for the adjustable interest rate feature, these Institutional loans are similar to the loans made for generations (and still made) by private lenders, usually negotiated by and sometimes serviced by loan brokers. These loans from private lenders arc sometimes referred to in the vernacular of loan brokers as "hard money loans," although that term generally means any cash loan, as distinguished from credit extended by a seller.

HOME EQUITY LINES OF CREDIT

Another relatively new type of junior loan being marketed by banks and S&Ls is the "home equity line of credit." The line of credit is an extension of open credit up to certain agreed limits, secured by a second mortgage on the home. The borrower simply writes checks against the credit line and pays interest on only that amount of credit actually used (funds borrowed). Payments are made according to terms set by the lender, terms that often are subject to change by the lender from time to time.

SELLER CARRY–BACK

An owner who has a considerable equity in the home is often asked to "take back a second" as part of the purchase price of the property. This procedure enables a buyer to acquire the property with a smaller cash down-payment, and it may provide the seller with a good investment opportunity for the sale proceeds. This extension of credit with assumptions of existing loans was the salvation of the real estate industry in the early 1980s when all hard money interest rates, including those for FHA and DVA loans, went to record highs for the 20th century.

In several types of transactions, the seller cooperates by lending directly, offering an assumable loan, or remaining involved through a wrap–around trust deed or a land contract. The seller acts as a lender to hold or "carry back" first, second, and/or third mortgage notes from the buyer. This is an alternative to borrowing from Institutional lenders.

- Seller can receive additional monthly income and might be eligible for capital gains tax deferment.
- Buyer does not need to qualify for an Institutional loan or pay loan origination fees and points.
- The terms and conditions of the mortgage are subject to negotiation between the seller and buyer, subject to federally mandated imputed interest rules.

Credit extended by a seller is a type of purchase money mortgage.

SECURITY FOR THE LENDER

Security is provided by the owner's equity in the property, even though the loan secured by the property is in a secondary position.

REQUEST FOR NOTICE OF DEFAULT

A junior lienholder or other parties with interests in the property may record a "request for notice of default," in which case the county recorder must notify the beneficiary of a second trust deed if a default is recorded by the first trust deed lienholder. The notice informs the junior holder so that the junior holder can reinstate the first trust deed to prevent foreclosure and thus protect the junior lienholders position.

SPLIT–RATE MORTGAGE

A new mortgage instrument, the split–rate mortgage, has been called the first true hybrid of an ARM with a fixed–rate mortgage. It is a half–fixed, half–adjustable loan that could become attractive to both consumers and lenders.

One of the attractive features of this new mortgage instrument is its anticipated ability to attract foreign–held dollars into American home mortgages. Because the ARM portion of the mortgage will be tied to the most popular international capital–market rate index, it is expected that it will attract into the American home–buying market billions of foreign–held dollars that are now being invested outside the United States. That market rate index is the international capital market's most commonly used money–cost yardstick–LIBOR, the London inter–bank offering rate. The advantage of using LIBOR rather than U.S. Treasury bill rates or Federal Home loan Bank cost–of–funds rates, is that it opens the door to lenders in other parts of the world whose investments are tied to LIBOR.

Previously, mortgage borrowers have had to choose between ARMs or fixed–rate alternatives. This new split–rate mortgage offers a combination of the two. For example, a split–rate might be offered this month at a 5% fixed rate. It would not change during the life of the loan. On top of the fixed–rate coupon or note would be an adjustable–rate coupon or note, with a current yield of possibly 4½%, tied to LIBOR. It would be designed to carry a lower rate than fixed–rate conventional loans, making it attractive to borrowers.

ASSUMPTION OF AN EXISTING LOAN

A buyer may wish to take over (assume, become primarily liable for) an existing loan on a property if the terms and conditions are more attractive than new financing, such as a lower interest rate or a longer amortization.

- **Restrictions** – Many loans are not assumable or may be assumable only if the interest rate is increased (in many cases, to the current market rate) at the time of assumption. If uncertain, one should read the existing mortgage agreement and consult an attorney for clarification.

- DVA and FHA loans are always assumable and maintain the same terms and conditions.

- Some fixed rate mortgages and variable interest rate mortgages are assumable.

- **Statute and Case Law** – The California Supreme Court prohibited state chartered lenders from exercising due–on–sale clauses on their real estate loans unless the lender could prove a threat to the loan security. However, the federal Garn–St. Germain Act of 1982 preempted state prohibitions.

- **Liability** – In most instances, the buyer becomes primarily liable for the existing loan and the seller becomes secondarily liable. A seller may be released from all liability through a novation.

  - The Veterans Administration requires a **"**release of liability**"** to relieve the seller of primary responsibility for a DVA loan with no change in terms and conditions.

  - FHA requires a **"**substitution of liability**"** and terms and conditions will remain the same.

- **Qualifying** – Except for FHA and DVA loans, the lender may qualify the assuming party, charge an assumption fee, and renegotiate the loan at different terms and conditions.

- **Subject To** – If an existing loan contains no enforceable due–on–sale clause, the property can be sold **"**subject to**"** the existing loan, in which case the buyer's only risk is his equity.

AITD/WRAP-AROUND

An **all–inclusive trust deed** (AITD), also called wrap–around, is a junior trust deed used to finance the sale of property, taken by a lender or carried back by the seller in an amount to cover any existing trust deeds on the property as well as any additional amount, all provided for in one junior trust deed at one interest rate.

- **Subject To** – An AITD is commonly used to preserve existing trust deeds at a favorable interest rate and avoid the costs of refinancing. It is normally used when there is no enforceable alienation clause on the existing encumbrance. (Rarely the case today except for FHA and DVA financing.) The property is purchased subject to existing loans. The seller pays off existing first trust deed payments with payments made by the buyer on the AITD.

- **Market** – The AITD is frequently used in a tight money market or when interest costs and loan charges are high. It may have more price and sales flexibility, due to the built–in financing terms.
- **Title** – Legal title is conveyed by grant deed and is insurable by a policy of title insurance.
- **Default** – If set up with a trustee handling all payments and holding the trust deed, both buyer and seller can be protected from default. If it is a purchase money transaction, deficiency judgments are not applicable. It retains favorable loan terms on existing loans in the event of foreclosure.
- **Lock–In** – An AITD can be used where an existing note contains a lock–in clause which prohibits prepayment of a loan.

☞*Example of AITD Financing*

A property is sold for $150,000. The existing first trust deed is $50,000 payable at $450 per month including 10% interest. There is also a second trust deed on the property for $30,000 payable at $350 per month at 11½%. The purchaser made a down payment of 10% of the selling price. The entire AITD of $135,000 ($150,000 minus $15,000 down payment) has a monthly payment of $1,494 including 13% interest.

Calculation of seller's effective interest:

AITD:$135,000 x 13% annual interest = $17,550

Exiting loans

1st TD	*$50,000 x 10% =*	*$5,000 annual interest*
2nd TD	*$30.000 x11 ½% =*	*$3,450 annual interest*
Total	*$80,000*	*$8,450*

$17,550	*AITD annual interest*

–8.450	*Existing loan's annual interest*
$9,100	*Seller's net annual interest received*
$135,000	*AITD loan amount*
–80.000	*Existing loans*
$ 55,000	*Seller's equity*

Seller's Net /Seller's Equity =$9100 / $55,000 = 16.545% =16.55% = effective interest

Seller makes a profit on the existing loans since purchaser is paying 13% on the entire AITD which includes existing loans payable at lesser interest rates. Seller receives an additional 3% interest on the first trust deed of $50,000 and an additional 1 ½% on the second trust deed of $30,000 and the full 13% on the seller's equity portion of $55,000.

ADVANTAGES TO BUYER AND SELLER

Relatively low down payments and below market interest rates are frequently offered with an AITD. In addition:

- The purchaser may be able to obtain a property for which qualifying may otherwise have been difficult.
- It may be possible to acquire a larger property with a lower down payment (utilizing more leverage).
- One monthly installment payment is required rather than payments on separate notes.
- When the seller becomes the lender, the parties are not subject to the stringent controls of Institutional lenders.
- The seller's (lender's) effective interest yield will be very attractive.

PROCEDURES

Setting up an AITD could include:

- Renegotiating or paying off any existing loans which restrict alienation.
- Constructing a realistic payment schedule to cover outstanding balances, periodic payments, and any balloon payments which may pertain to existing loans.
- Deciding who will administer and pay for collection procedures. Determining what conditions define default.
- Having an attorney compose the necessary documents and agreements in terms acceptable to the title insurance company insuring the property and acting as trustee.

PACKAGE TRUST DEED

A **package trust deed or package loan** is a type of self–amortizing loan that takes the fixed–rate deed of trust one step further. It is not only secured by the real property, but it includes some of the appliances and other items that are a part of the structure to be financed. Items often included in the package deed of trust are stoves, ovens, dishwashers, carpet, heating, and air conditioning. One reason to include such easily removed items in a deed of trust is that the lender is better able to protect the investment. The property is more sellable with these items in place. An important advantage for the borrower is that he or she can include the cost of these items in the deed of trust and, therefore, be able to budget their cost. This instrument is frequently used by institutions licensed as personal property brokers, such as finance companies.

☞ ***A loan used in home financing that is secured by a combination of real property, improvements, movable equipment and/or appliances.***

OPEN–END TRUST DEED

As the name implies, the open–end deed of trust has no due date. The balance is usually not paid off and can be as little as one dollar. Thus, the mortgage is still alive and the lender can lend funds without having to start the procedures of a new loan; the collateral for the original loan is still used for the new funds. This type of loan is used primarily to finance agriculture in rural areas, where the lenders are quite familiar with the borrowers and their financial capabilities. It has some use in today's real estate market. Additionally, certain deeds of trust with stated maturities have open–end provisions which allow for additional advances during the life of the trust.

☞ ***An open–end trust deed allows additional amounts of money to be lent to borrower in the future under the same terms and conditions as the existing trust deed.***

BLANKET TRUST DEED (WITH RELEASE CLAUSE)

A blanket deed of trust with release clause is normally used for financing the purchase and development of land or subdivisions. Under the blanket deed of trust, the developer has the opportunity to include more than one piece of property, usually subdivision lots, with the ability to release a lot from the mortgage as it is sold. This means, for example, if a developer has a subdivision with 100 lots financed under a blanket deed of trust with release clause, as the developer sells one of the lots, the developer pays off an amount of at least 1/100th of the total amount, but it may be as much as 110 to 120 percent of that fractional figure, dependent upon lender requirements. The lender will release the parcel or lot from the mortgage, thus giving the person purchasing the lot clear title. Without the release clause capability, the developer would have to sell all 100 lots before clear title could be issued for any of the lots.

- **Effect** – As specified portions of the loan are paid, specific parcels are released from the blanket encumbrance, if a release clause is in existence. A deed of partial reconveyance is used to effect this.

- **Use in Subdivisions** – A responsible land promoter will usually secure a special release clause from the lender if the separate subdivided parcels encumbered under the blanket trust deed were originally part of one large parcel. (Protects individual smaller parcel buyers in case of a defaulting developer and/or promoter.)

- **Income Tax liens** – Involuntary blanket encumbrances may be placed on properties of an individual by the federal government for nonpayment of income tax.

☞***A blanket trust deed is one loan instrument covering two or more parcels. Borrower may pledge more than one parcel as security for a loan.***

REAL PROPERTY SALES CONTRACT

DEFINITION

"*An agreement wherein one party (the seller) agrees to convey title to real property to another party (the purchaser), upon the satisfaction of specified conditions set forth in the contract and which does not require conveyance of title within one year from the date of formation of the contract****"*** (Civil Code Section 2985)

Also called ***land contract***, ***agreement of sale***, ***conditional sales contract, installment sales contract***, ***contract for deed*****, or *contract to sell*.** The essential characteristic is that the seller retains title to property to the end of the contract term. Buyer receives possession at inception, but not a deed.

A land contract is not a true mortgage. It is mentioned in this section only because it is used in some types of transactions. As its name implies, it is a contract, and if the purchaser meets all of the provisions of the contract, he or she may sometime in the future get a deed to the property. An agreement of sale has been used in the past to sell recreational land where the developer, due to previous financing, cannot give clear title to the property until the previous financing is paid and released. It is also used to sell low–quality rental property to the present tenant.

There are some severe drawbacks to this type of financing, including the following:

- The installment sales contract, if not recorded, would allow a less–than–honest developer to sell a piece of property more than once.
- A title policy may not be secured on the property.
- Most severely, even though the purchaser makes all of the payments in good faith, he or she may not be able to receive clear title due to insanity of the seller or a death, divorce, or bankruptcy concerning the seller or a member of his or her family.

Recognizing all of the possible dangers to a purchase of recreational or resort–type lots, the federal government through HUD, established the Office of Interstate Land Sales Registration with the passage of the Interstate Land Sales Full Disclosure Act in 1969. The purpose of the act was to police the sale of land by developers in subdivisions of 50 lots or more for lots less than 5 acres. Under the act each developer must prepare and submit an Office of Interstate Land Sales Property Report Form. The developer must supply this report to the prospective purchaser before he or she signs any contract. If the purchaser does not receive a copy of the report prior to or at the time he or she enters into a contract with the seller, the purchaser may terminate the contract by notice to the seller. The purchaser must sign a statement that he or she has received a copy of the property report.

CHARACTERISTICS OF LAND SALES CONTRACT

- **Parties** – The parties to a land contract are vendor (owner or seller; extender of credit) and vendee (purchaser or borrower, "equitable owner").

- **Resale** – Either party may transfer the property.

  - The vendor may sell the title but must assign the contract

  - Vendee may assign or sell the property unless the contract prohibits it. Prepayment or sale which may prepay the loan can be prohibited only up to 12 months from the date of contract.

- **Encumbrances** – Both parties may encumber the property, within limits.

  If a contract is unrecorded, the vendor may encumber the title subject to the following:

  - if all encumbrances (existing and new) will exceed balance due on the contract, written consent of the vendee must be obtained.

  - Payments on a trust deed cannot exceed the payment due from the vendee on the land contract unless vendee consents in writing.

- Payments received from the vendee must first be applied to any payments due on existing trust deeds.

- The vendee may encumber the equitable interest but cannot use legal title as security, and may homestead the equitable interest.

- **Reasons for Use** – Land contracts are used by the California Department of Veterans Affairs in Cal–Vet purchases. Other circumstances for using them might include:

    - When a buyer does not have sufficient down payment or credit for a traditional loan

    - During a tight money market where traditional loans are hard to get.

    - When seller does not wish to give legal title or buyer does not wish to receive legal title.

    - To retain favorable trust deed loans existing on a property which vendor would regain in the event of repossession.

- **Safeguards** – Both vendor and vendee should be alert to the possibility of the lender's enforcement of a due–on–sale clause, the requirement of a disclosure statement, and the advisability of a review of the transaction by an attorney.

DISADVANTAGES

Because title is not conveyed by a land contract in the usual manner, there are a number of possible complications.

- If the vendee defaults and refuses to move or pay, the vendor must file court action.

- Court action is required for the vendor to regain clear title when the contract is recorded and the buyer defaults and refuses to record a release.

- Title may be subject to mechanics or other liens.

- The contract may prohibit assignment by the vendee.

- The vendee's equitable interest is not attractive security for loans.
- The vendee might receive defective title or no title at all upon conclusion of the contract.
- The vendee may be faced with expensive court proceedings to acquire title if the vendor dies or becomes incompetent or bankrupt.

REMEDIES FOR DEFAULT

If the vendee defaults, the vendor may:

- Sue for specific performance
- Sue for damages.
- Agree to rescind.
- Bring **“**quiet title action**”** in court' if title is clouded
- Attempt to declare a forfeiture and retain money paid as liquidated damages. (Court allows reasonable damages only.)

GRADUATED PAYMENT MORTGAGE (FHA 245)

A graduated payment mortgage loan is a fixed rate loan on which the monthly payments begin at a level lower than that of a level payment fixed–rate loan. During a period the length of which is fixed at loan origination (the graduation period), the monthly payment amount gradually rises to a level sufficient to amortize the remaining principal balance over the remaining term of the loan.

A GPM provides that monthly payments are initially lower in the first 5 to 10 years with a gradual annual increase to a predetermined point, after which they remain constant.

The graduation periods, the rate of increase, and the interest rate are fixed when the loan originates.

Available only to owner–occupants, only for single–family dwellings, and can be assumed.

These programs are designed primarily for younger buyers whose incomes are expected to rise as the monthly payments increase.

FIVE DIFFERENT GPM PLANS

	Percentage of monthly payment increase	During the first
Plan I	2 ½% each year	5 years
Plan II	5% each year	5 years
Plan III	7 ½% each year	5 years
Plan IV	2% each year	10 years
Plan V	3% each year	10 years

While five optional plans exist, the most popular one is a five–year plan–Plan III. Initial payments are not large enough to cover all the interest due, so the shortfall is added to principal, with consequent negative amortization. Monthly payment amounts are increased 7.5% per year, with the effect that positive amortization begins to appear during the fifth year, after which the payments are increased to the point that full amortization occurs during the subsequent 25 years. All GPMs, whether FHA or conventional, follow this pattern.

These loans have not been used for some time, particularly during periods when 30–year, fixed rate loans are easily available.

RESIDENTIAL LEASE–PURCHASE AGREEMENTS.

Like the delayed sale in the land contract, various lease arrangements can be used to finance or otherwise ease a sale.

This device is used mainly when financing is difficult to obtain. It is utilized to take advantage of the possibility that better financing may be available at a later date.

The lease agreement and sales contract are drawn up simultaneously, with a delayed closing date on the sales contract. The sales price is specified, and an agreement to purchase on or before some stated date. The “locked–in” purchase price benefits the lessee/buyer. There is nearly always a payment of a deposit toward a down payment. Payment of monthly rental payments by lessee/buyer covers the underlying mortgage.

- The monthly payment may exceed mortgage payments (benefit to lessor/seller).
- The seller–lessor may credit a portion of the payment toward the purchase price (benefit to lessee/buyer).
- The contract usually provides for forfeiture of deposit if the lessee/buyer decides not to purchase the property (lessor/seller benefit).
- There are tax benefits to the lessor/seller by renting property.

This procedure may require approval from the underlying lender if there is a due–on–sale clause in existing financing.

Lease With Option to Buy

Similar to the lease–purchase agreement, this procedure combines the lease with an option to buy rather than a contract to buy.

- A deposit is not necessarily made.
- The lessee has the right to exercise the option to purchase for as long as the lease is in effect.

Sale–Leaseback

This arrangement between seller–lessee and buyer–lessor releases capital which the seller has tied up in property at an old basis with no depreciation left. The seller is normally a business which owns the premises and continues to occupy them as lessee after the sale.

- The seller can retain an ideally suited property for use of the business.
- The seller–lessee can deduct full rental. (Advantage over borrowing on equity and deducting interest only.)
- The buyer–lessor gets an ideal tenant who manages the property, as well as depreciation benefits and appreciation potential.

BUYDOWNS – TEMPORARY

With a buydown the effective interest rate is reduced or "bought down" during the initial term of the loan for the borrower by contributions made by other parties, e.g., the builder–developer or seller. The third party, in effect, pays for part of the interest in advance.

- The buydown cash is usually deposited into a non-revocable savings account with an automatic payment to the lender.
- The lower interest rate usually lasts two to three years.
- Costs of the buydown may be passed to the buyer–borrower in the form of a higher sales price.

Some S&Ls now offer borrowers an opportunity to buy down the terms of an adjustable rate mortgage:

- **Start rate** – The borrower may be permitted to reduce the starting interest rate by the payment of a certain fee. Example: The lender may reduce the starting interest rate by 1/8% for a consideration of 1/4 of a point.
- **Stated cap** – The lender may be willing to reduce the stated interest rate cap. Example: Reduce the rate cap by 1/8% for a consideration of 1/4 of a point.
- **Margin** – The lender may reduce the interest margin. Example: A reduction of 1/8% for a consideration of 3/4 of a point.

SHARED APPRECIATION MORTGAGE

A shared appreciation mortgage is a first mortgage loan offered by a lender at a below–market interest rate in exchange for a percentage share in the future gain of the property's value. Common characteristics include a fixed interest rate, and a discounted rate in exchange for equity share. The borrower makes no guarantee on the amount of appreciation in property value.

- Ratios may vary for individual lenders.

- Most common is a 33.3% reduction in interest rate for a 33.3% share of the increased value of the property upon its sale or at a predetermined date.
- The lender may be required to set a maximum "call date" or "balloon date," after which the lender may enter into a new SAM loan.
- **Advantages** –More borrowers are able to qualify due to the lower interest rate, lower payments, and lower down payment. During an inflationary period, the lender's yield is greater than on a conventional loan, and there may be tax advantages due to the deferred yield.

EQUITY PARTICIPATION PLAN

An **equity participation plan** involves an owner/occupant and an investor who share the cost of ownership, equity, and tax benefits. A common application is that parents assist a son or daughter to acquire a home by putting up the cash for a down payment in exchange for an equity position in the property. Also, an employer might join with a transferred employee in buying a house in a high cost area to facilitate the transfer. The employee would then be given an option to buy out the employer at a stated time.

REVERSE ANNUITY MORTGAGE

A **reverse annuity mortgage** is a loan which utilizes the equity in a homeowner's residence to make payments on the property or to provide living expenses for persons retired with fixed retirement or pension incomes.

The lender makes the payments on the property or provides cash for the owner from the equity for a fixed period, until a specified loan–to–value ratio is reached or until the homeowner dies.

The lender charges interest for the use of the money.

Upon sale of the property, the amount paid through the annuity will be repaid from the equity in the property.

This may be especially attractive to an elderly homeowner, as it eliminates the need to make monthly payments on the residence or provides cash for living expenses.

RAMs are available only for those 62 or older The home must be free and clear, or have a low existing loan. The program is for single–family dwellings only, except for FHA approved condos. Neither Fannie Mae or FHA makes direct reverse loans. Instead, approved lenders make the loans with Fannie Mae and FHA backing.

TWO–STEP MORTGAGE

The purpose of a **two–step mortgage** is to allow home buyers to qualify for a loan based on lower interest rates and therefore lower payments. You will find that the two–step mortgage has many of the features of **“**loans amortized for 30 years but due in 5 or 7 years**”** discussed in previous section of Balloon Mortgage.

The chief advantage of the two–step over a balloon mortgage or the previously discussed **“**amortized for 30 years, but due in 5 or 7 years**”** loan is that borrowers aren't forced to move or refinance–they simply endure a one–time adjustment to the interest rate.

CHARACTERISTICS OF TWO–STEP MORTGAGE

- A fixed rate of interest is charged for the initial period, usually seven is based on 30–year payment schedules.
- An automatic conversion following the initial period may be another fixed rate years, that is lower than the standard for 30–year, fixed rate loans.
- Amortization at the then prevailing rate. It could be adjustable but with a lifetime interest ceiling set at the time of the loan, at no additional cost. The conversion feature assures the borrower that the otherwise large balloon due in seven years will come from the same lender, only at a different rate. Stated differently, the two–step guarantees fixed rate financing for the entire loan term without having to come up with a sizable balloon payment.
- Because they qualify for purchase by FNMA in the secondary market (discussed in earlier chapter), loan amounts vary according to the current limits set by FNMA.

BIWEEKLY FIXED RATE LOANS

????Biweekly fixed rate loans shorten the life of the loan because the principal is decreased faster. Borrowers make 26 payments per year rather than 12 payments per year. Making a payment every two weeks means that the payment is applied to decrease the unpaid balance on the loan every two weeks. Since interest can only be charged on the unpaid interest due, then the remaining amount directly reduces the principal.

How much faster is a loan paid off using biweekly instead of monthly payments? A rule of thumb is that it is *one–third faster*–a traditional 30–year monthly amortized loan can be paid off in about 21 years using biweekly payments. Certain facilitating companies can set up this procedure for you, with fees in the range of $500.00 if your lender does not provide the opportunity.

Biweekly payment programs are approved by Fannie Mae and Freddie Mac; thus there is a secondary market for these loans. Some borrowers prefer the biweekly, as opposed to the traditional monthly, payment loans because of the savings in interest costs and faster loan payoff.

For borrowers who do not wish to enter into a formal biweekly agreement–that is, for those who do not wish to tie themselves down to a binding commitment every two weeks–but who still want to reduce interest costs, there are solutions. For example, the borrower can accomplish similar results, though with a slightly longer payoff period, by making a 13th payment toward principal reduction each year. Or the borrower could increase each regular installment by 1/12 of the principal amount of the payment. Of course, these prepayments can be accomplished only if they are not prohibited under the terms of the promissory note. If the borrower makes the 13th monthly payment, he/she must make sure the lender is aware of its purpose–*principal reduction only.*

☞ INTERNET WEB LINKS

www.bea.doc.gov	Bureau of Economic
www.bls.gov	Bureau of Labor Statistics
www.census.gov	US Census Bureau

www.eia.doe.gov	Energy Information Administration
www.federalreserve.gov	Federal Reserve
www.homes.com	Homebuyers website
www.homeseekers.com	Homebuyers website
www.homestore.com	Homebuyers website
www.realtors.com	Homebuyers website
www.irs.gov	Internal Revenue Services

CHAPTER QUIZ

1. Adjustable rate mortgages offered by various lenders at any given time may differ in:

    A. Interest Rate caps
    B. The index used
    C. The adjustment period
    D. All of the above

2. Reasons for using alternative financing do not normally include:

    A Low interest rates and high availability of money
    B California's heavy dependency on out–of–state mortgage funds
    C Tight money market
    D A buyer who is unable to qualify for traditional financing

3. Negative amortization means:

    A The loan is never amortized
    B The loan balance decreases with each monthly payment
    C The loan balance does not change with each money payment
    D The loan balance increases with each money payment

4. An AITD is an:

    A All interest trust deed
    B Alternative investment trust deed
    C Attenuated insurance trust deed
    D. All inclusive trust deed

5. The maximum interest rate that a lender can charge under an ARM is called the

A. Cap.
B. Margin.
C. Term.
D. Adjustment.

6. In an ARM loan, when the initial interest rate is abnormally low it is known as the _______ rate.

A. Index
B. Teaser
C. Capped
D. Basement

7. Under an ARM loan, the distance between the actual rate paid by the borrower and the index is called the

A. Adjustment.
B. Cap.
C. Term.
D. Margin.

8. An AITD:

A Is subordinate to the underlying existing loan(s)
B Is a junior trust deed
C Can be a purchase money transaction
D. All of the above

9. The use of an owner's equity to pay scheduled payments is called:

A Reverse annual mortgage
B Revised annual mortgage
C Reverse annuity money
D. Reverse annuity mortgage

10. How much faster is a loan paid off using biweekly instead of monthly payments on a 30 years loan?

A 1/5
B 1/4

C 1/3
D. 1/2

Answer Key: 1–D, 2–B, 3–D, 4–D, 5–A, 6–B, 7–D, 8–D, 9–D, 10–C

CHAPTER 10: REGULATION OF LOAN BROKERAGE

PREVIEW

In this chapter we will discuss the various regulation of loan brokerage. We will learn the hard money loans differ from other loans as well as who makes these loans and why. We will also understand the basis and requirements of Article 1, 5, 6 and 7 of the real estate law.

ARTICLE 1, REAL ESTATE LAW–BROKER LICENSE REQUIRED

Article 1 of Chapter 3 of the California Real Estate law, "Real Estate Regulations" defines the activities which require that a person be licensed as a real estate broker (or be a licensed real estate salesperson in the employ of a broker). In some of these activities the person is not dealing in real estate, but is dealing in "real estate paper"– financing instruments (promissory notes) secured by security instruments carrying liens on real property (mortgages, trust deeds, and land contracts).

DEFINITIONS

- **Loan Brokers** – A real estate broker's license is required for a person who, in expectation of compensation, for others, solicits borrowers or lenders for or negotiates or collects payments or performs services for borrowers or lenders or note owners, in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.

- **Agent** – A broker's license is also required of a person who, for compensation, acts as an agent in the sale, purchase, or exchange of existing "real estate paper."
- **Principal** – Article 1 also defines "broker" as including any person who engages as a principal "in the business" of buying, selling, or exchanging with the "public" real property sales contracts, or promissory notes secured by liens on real property (real estate paper).
- **"In the Business."** – The term "in the business" is specifically defined as it applies in this law as anyone who:
  - Acquires for resale to the public (and not as an investment) eight or more such items of real estate paper during a calendar year or
  - Sells or exchanges eight or more items of such paper with the public during a calendar year.

Any such person (in any combination of such transactions) must be a broker or deal through a broker.

☞ ***For complete details of article 1, please visit website www.leginfo.ca.gov (California Business and Professions Code)***

ARTICLE 5–TRANSACTIONS IN TRUST DEEDS AND SALES CONTRACTS

Article 5 "Transactions in Trust Deeds and Real Property Sales Contracts," is applicable to real estate licensees engaged in the business of brokering mortgage loans or acting as agents in the sale, purchase or exchange of existing loans.

☞ ***The purpose of Article 5 is to curb broker abuses in arranging loans.***

The "mortgage loan broker" as defined in Section 10232, is a broker who meets the threshold criteria:

- Negotiates loans or sales of loans at a rate of *20 or more per year* in an aggregate amount of more than *two million dollars ($2,000,000).*

- Makes collections of payments in one year in an aggregate amount of five hundred thousand dollars ($500,000).

SELF–DEALING BROKER

A real estate broker who proposes to solicit and accept funds to be applied to a purchase or loan transaction in which the broker will directly or indirectly obtain the use or benefit of the funds, other than commissions for services, is defined as a **"**self–dealing**"** broker (Section 10231.2).

- **Application** – The broker who negotiates a real estate loan or the sale of an existing note and trust deed must provide the lender or purchaser with a specific disclosure statement that describes the note and trust deed being funded or offered for sale, details about the borrower, and other pertinent information.

☞***Effective July 1, 1998, every mortgage loan solicitation by a real estate broker shall include the broker's license number as well as a special Department of Real Estate consumer telephone number.***

DISCLOSURE REQUIREMENTS

The disclosure statement which previously was provided to only a relatively few lenders and purchasers of financing instruments is now to be given to practically all non–Institutional lenders and note purchasers.

- Form – Since January 1, 1989, all brokers must provide the ***Lender/Purchaser Disclosure Statement*** (RE 851) (see Form 10–1) to lenders and note purchasers except to those institutions specifically exempt (banks, savings and loans, insurance companies, pension trusts, FNMA, FHLMC, etc.).

- **Timing** – As early as practicable before accepting any funds. (A self–dealing broker must submit the form 24 hours before accepting funds.)

- **Signatures** – The form must be signed by the prospective lender or purchaser, and by the broker.

- **Customer Copy** – A copy must be provided to the lender or purchaser.

- **Retention** – The broker must retain a copy for 4 years.

- **DRE Filing** – In addition, a **"**self–dealing**"** broker must submit to the Department of Real Estate a copy of the disclosure statement and a concurrent statement that the submittal is pursuant to §10231.2.

    - **Timing** – The disclosure statement must be submitted to DRE *prior to* making any presentation to the lender or purchaser.

DISCLOSURE TO LENDER

"(a) If the real estate broker is ... negotiating a loan to be secured by a lien on real property or on a business opportunity, the statement required to be given to the prospective lender shall include, but shall not necessarily be limited to, the following information:

- **Property Identification** – Address or other means of identification.

- **Market Value** – Estimated fair market value of the securing property, and if the broker is relying on an appraisal... the date that the appraisal was made and the name of the person who made the appraisal.

- **Improvements** – Age, size, type of construction and a description of improvements to the property.

- **Borrowers** – Identity, occupation, employment, income, and credit data about the prospective borrower or borrowers as represented to the broker.

- **Terms** – Terms of the promissory note to be given to the lender.

- **Liens** – Pertinent information concerning all liens against the securing property and, to the extent of actual knowledge of the broker, pertinent information about other loans that the borrower expects or anticipates will result in a lien being recorded against the property securing the promissory note to be created in favor of the prospective lender.

- **Loan Servicing** – Provisions for servicing of the loan, including disposition of the late charge and prepayment penalty fees.

- **Joint Parties** –Detailed information concerning any joint beneficiaries or obliges.

- **Self**–Dealing Broker – If the solicitation is subject to the provisions of Section 10231.2 [self dealing], a detailed statement of the intended use of the funds and benefits to the broker.

DISCLOSURE TO PURCHASER

(b) If the real estate broker is... negotiating the sale of a real property sales contract or promissory note secured directly or collaterally by a lien on real property, the statement required to be given to the prospective purchaser ... shall include, but shall not necessarily be limited to, the following information:

- **Property Identification** – Address or other means of identification of the real property that is the security for the tractor's or vendee's obligation.

- **Market Value** – Estimated fair market value of the real property, and if the broker is relying on an appraisal in estimating the fair market value, the date that the appraisal was made and the name and employment of the person who made the appraisal.

- **Improvements** – Age, size, type of construction and description of improvements to the real property if known by the broker.

- **Trustor or Vendee** – Information available to the broker relative to the ability of the trustor or vendee to meet his or her contractual obligations under the note or contract including the trustor's or vendee's payment history under the note or contract.

- **Terms** – Terms of the contract or note including principal balance owed. Servicing. Provisions for servicing of the note or contract, if any, including disposition of late charge, prepayment penalty or other fees or charges paid by the trustor or vendee.

- **Joint Parties** – Detailed information concerning any proposed arrange-ment under which the prospective purchaser along with persons not otherwise associated with him or her will be joint beneficiaries or obligees.

- **Dealer's Role** – A statement as to whether the dealer is acting as a principal or as an agent in the transaction with the prospective purchaser.

Exemptions From Coverage

The provisions of Article 5 do not apply to the following.

- **Broker Transactions in Connection With Sales** – The provisions of Article 5 do not apply to negotiation of a loan by or for a real estate broker in connection with a sale or exchange of real property where the real estate broker acted as an agent.

  Nor do the provisions of Article 5 apply to the sale or exchange by or for the broker of a promissory note created to finance the sale or exchange where the broker acted as an agent for one of the parties. This exemption applies regardless of the relationship between the time of the sale or exchange of the promissory note and the time of the sale or exchange of the property.

- **Broker Direct Benefit** – The above exemptions do not apply to negotiations of loans and sales or exchanges of promissory notes in connection with the financing of a real property sale or exchange transaction in which the broker, as a party, had a direct or indirect financial interest.

  Note:Section 10230(a) covers the exemption in connection with a broker sale or exchange but paragraph (b) of Section 10230 removes transactions from the exemption where the broker had a financial interest (was a principal rather than an agent).

Restrictions on Retention of Loan Funds

A person engaged in any of the activities listed below, either as an agent or a principal, shall not retain funds payable under the terms of a real property secured promissory note for more than 60 days, except with a written agreement with the purchaser or lender. (Business and Professions Code 10231.1) The following are activities covered by this restriction.

- **Soliciting(Servicing)** – Soliciting borrowers or lenders for loans or negotiating loans or collecting payments or performing services for borrowers, lenders or note owners in connection with loans secured by (directly or collaterally) by liens on real property or business opportunities.

- **Selling / Buying** – Selling, offering to sell, buying, offering to buy, exchanging or offering to exchange a lien secured by real property or a business opportunity and performing services for the holders thereof.

- **Acting as a Principal** – Acting as a principal in the business of buying from, selling to, or exchanging with the public, real property sales contracts or promissory notes secured directly or collaterally by liens or real estate or making agreements with the public for the collection of payments of for the performance of services in connection with sales Contracts or promissory notes secured by real property.

BROKER BENEFITS

- **Submission to the DRE when Broker Benefits** – When a real estate broker, who acts within the scope of the above, proposes or causes the solicitation and acceptance of funds to be applied to the purchase of a loan transaction where the broker will directly benefit (other than commission and costs), the broker must first submit a statement to the Department of Real Estate.

  The statement shall include:

  - a copy of the statement given to the person solicited,
  - that it is being submitted pursuant to Business and Professions Code 10231.2.

STATEMENT TO PERSON SOLICITED WHEN BROKER BENEFITS

When the broker benefits from a loan transaction, the broker will deliver, or cause to be delivered, a completed statement not less than 24 hours before (whichever is earlier) either the acceptance of any funds or the execution of an agreement to obligate the person to make the loan or purchase. The statement must be signed by the prospective lender or purchaser and by the broker (or a salesperson on the broker's behalf). The broker must keep a copy of the statement for four years. The contents of the statement shall include, but is not limited to:

1. address or identification of the property securing the borrower's obligation.

2. estimated fair market value. If the broker relies on an appraisal, the date of the appraisal and who made it for whom.

3. age, size, type of construction and a description of the improvements if contained in the appraisal or as represented by the prospective borrower.

4. identity, occupation, employment, income and credit data of prospective borrower(s) as represented to the broker by the borrower(s).

5. the terms by the promissory note to be given to the lender.

6. information concerning all encumbrances that are liens against the securing property as known by the broker and pertinent information about other loans the borrower expects will result in being recorded against the property.

7. any provisions for servicing the loan including disposition of late charges and prepayment penalty fees.

8. information concerning any arrangement under which the prospective lender along with persons associated with him or her will be joint beneficiaries or obligees.

9. if the solicitation is subject to the provisions of Section 10231.2, which involves collection of advance fees, there must be a detailed statement of the intended use and disposition of funds solicited including any direct or indirect benefits to the broker.

   If the broker is selling existing obligations secured by real estate as either a principal or as an agent, the following must be included:

10. ability of the trustor or vendee to make his or her payments including the trustors or vendees payment history

11. a statement as to whether or not the dealer is acting as a principal or as an agent in the transaction.

EXEMPTION FROM STATEMENTS TO DRE AND PERSONS SOLICITED

Disclosure Statements do not apply to the offering of a security pursuant to Article 6 (covered later in this chapter) or transactions subject to the Corporate Securities Law

APPLICATION TO CORPORATE BROKERS

The disclosures apply to funds which are intended for the direct or indirect use or benefit of any officer, director or stockholder (holding more than 10% interest in the corporation) when the funds were solicited by the corporate real estate broker.

SOLICITATION AND ACCEPTANCE OF FUNDS OTHER THAN FOR SERVICES SPECIFIED STATEMENT AND ITS USE

- **10231.2(a).** A real estate broker who, through express or implied representations that the broker or salespersons acting on the broker's behalf are engaging in acts for which a real estate license is required by subdivision (d) or (e) of Section 10131, proposes to solicit and accept funds, or to cause the solicitation and acceptance of funds, to be applied to a purchase or loan transaction in which the broker will directly or indirectly obtain the use or benefit of the funds other than for commissions, fees and costs and expenses as provided by law for the broker's services as an agent, shall, prior to the making of any representation, solicitation or presentation of the statement described in subdivision (b), submit the following to the Department of Real Estate:
    - A true copy of the statement described in subdivision (b) complete except for the signature of the prospective lender or purchaser.
    - A statement that the submittal is being made to the department pursuant to Section 10231.2...

ADVERTISING BY LOAN BROKERS

A "mortgage loan broker" who meets the threshold requirements (20 or more loans totaling $2 million per year) must submit a copy of all related advertising to the Department of Real Estate for clearance.

- **Advertising** includes newspapers, circular form letters, brochures or similar publications, signs, displays, radio broadcast or telecasts which concern:

- Use of terms, rates, conditions or the amount of any loan or sale.
- The security, solvency or stability of any person carrying on the activities of the loan brokerage activities.

◆ **Not Considered Advertising**

- Information distributed to other brokers and persons who the broker had previously acted for as an agent.
- Information restricted to the identification and description of terms of loans. mortgages, deeds of trust and land contracts offered for funding or purchase through the loan broker.
- Advertising a real property security (Article 6 of the real estate law).

◆ **Premiums** – A broker may not advertise a premium or gift to induce a borrower, lender or purchaser.

◆ **Different Yield** – A broker may not advertise a yield different than the rate on the note unless the advertisement states the rate on the note and the discount from face value for which the loan can be purchased.

◆ **Submission of Advertising** – The submission of advertising for approval to the Department of Real Estate was formerly mandatory. Business and Professions Code Section 10232.1 has changed "shall "to "may" which makes the submission voluntary.

☞ ***When submitted, a true copy shall be accompanied by a fee not to exceed $40. The approval is for five years. If advertising submitted for approval is not given within 15 calendar days, the proposed advertising shall be considered approved.***

◆ **Advertising Identification** – The Department of Real Estate assigns an identifying number to each advertisement submitted for approval. Brokers who use visual advertisements will include the number in their advertisements.

- **Advertising Criteria** – The commissioner may prevent or halt the publication of false, misleading or deceptive advertising. Commissioner's Regulation 2848 of the Commissioner's Regulations sets forth examples of false, misleading and deceptive advertising.

BROKER ADVANCING OTHER THAN OBLIGOR'S FUNDS

If, in servicing a real property secured loan, the broker pays funds to the lender other than the funds of the obligor, the broker must give written notice to the lender or owner of the note of this fact. The notice must be given within 10 days of making any such payment and include the date and amount of payment, the name of the person to whom payment was made, the source of funds and the reason for making the payment. (Business and Professions Code 10233.1)

Note:Prior to this requirement some mortgage brokers would hide the fact that a borrower was in default from the lender while trying to get the borrower current. They felt it could be bad for business, to get additional lenders, when a borrower was constantly late with his or her payment.

MORTGAGE LENDER / INVESTOR DISCLOSURE STATEMENT

In addition to the borrower disclosure statements, which are required in loan transactions other than federally related loans, there is a lender/investor disclosure statement. This statement is limited to:

1. private lenders,
2. small pension funds (less than $15,000,000 in assets),
3. credit unions.

RECORDING OF TRUST DEEDS

If a real estate broker negotiates a loan secured by a trust deed on real estate, the broker must record the trust deed (naming the lender as beneficiary) prior to the release of any funds (unless the lender provides a written authorization for a prior release of funds.)

If the funds are released on the written authorization of the lender prior to recording, the broker shall either record the trust deed within 10 days of release of funds or deliver the trust deed to the lender with a written recommendation that it be immediately recorded.

RECORDING OF ASSIGNMENTS

☞ ***When a real estate broker sells or otherwise arranges a transfer of an existing trust deed or sales contract secured by real estateg the broker shall record the assignment naming the assignee as purchaser.***

Recording must be within 10 working days after the seller receives funds from escrow or the buyer for the assignment. As an alternative the broker may deliver the real property sales contract or trust deed to the purchaser with a written recommendation that it be immediately recorded. (Business and Professions Code 10234)

ANNUAL REPORTS

A **"mortgage loan broker"** must file **annual** reports with the DRE, which must include a review by a licensed California independent public accountant of trust fund financial statements.

☞ ***For complete details of article 5, please visit website www.leginfo.ca.gov (California Business and Professions Code)***

ARTICLE 6 – REAL PROPERTY SECURITIES

Article 6 of the Real Estate Law (beginning with Business and Professions Code Section 10237) has been repealed as of January 1, 1998. The Department of Corporations has taken over responsibility for issuance of security permits. The Department of Corporations now has jurisdiction over all securities transactions.

ARTICLE 7 – MORTGAGE BROKER'S LOAN LAW

Article 7 is known as the **Mortgage Broker's Loan Law** or **Real Property Loan Law**. Under California law any person who negotiates a loan secured by real property for another and for compensation must be licensed as a real estate broker or salesperson. Article 7 regulates the licensee's activities as an arranger of loans.

☞ ***Article 7 sets forth disclosure requirements as well as limits on loan costs and fees that can be charged by a mortgage loan broker.***

PURPOSE

The purpose of the **Real Property Mortgage Loan Law** is to protect the borrowers of hard money loans, whether purchase money or not. The law requires that prospective borrowers be supplied with complete loan information. In other words, the broker must give the applicant a filled–in *Mortgage Loan Disclosure Statement* before the loan is agreed upon. This disclosure statement will give the borrower a reasonably close picture of the final amount of the loan.

MORTGAGE LOAN DISCLOSURE STATEMENT

The broker must provide the borrower with a disclosure statement containing complete loan information, including estimated loan costs, expenses, and commissions to be paid by the borrower.

Form 10–1 is a reproduction of the Mortgage loan Disclosure Statement produced by the California Department of Real Estate. It contains information about estimated costs, expenses, and commissions to be paid by the applicant for a loan. It also informs the borrower of the approximate net amount that will be received from the loan after paying commissions, costs and expenses, payoffs on liens against the property, and other incidental charges.

- **Standard Form** – The disclosure must be a form approved by the Commissioner and must include all information required by law.
- **Execution** – . It must be signed by the borrower and the licensee and delivered to the borrower before the borrower becomes obligated.
- **Retention** – A copy must be retained by the licensee for **four** years.
- **Delivery** – The disclosure must be delivered to the borrower regardless of loan amount.

PROVISIONS

Applicable to All Broker loans – Disclosure requirements and prepayment limitations apply to all loans negotiated by licensees unless the lender is an institution such as a bank or savings and loan association and the broker receives a commission not in excess of 2%.

Other provisions regulating costs and commissions apply only to:

- First trust deeds less than $30,000.
- Junior trust deeds less than $20,000.

The limitations as to loan costs and broker's commission only apply to smaller loans. The parties can agree to commissions and costs without limitation on the larger loans.

Form 10-1: Lender/Purchaser Disclosure Statement (RE 851)

STATE OF CALIFORNIA

DEPARTMENT OF REAL ESTATE
MORTGAGE LENDING

LENDER/PURCHASER DISCLOSURE STATEMENT
(Loan Origination)

RE 851A (Rev. 9/01)

DISCLOSURE STATEMENT SUMMARY

AMOUNT OF THIS LOAN *(SEE PART 3)* $	MARKET VALUE OF PROPERTY (SEE PART 8) $	TOTAL AMOUNT OF ENCUMBRANCES SENIOR TO THIS LOAN *(SEE PART 9)* $
TOTAL AMOUNT OF ENCUMBRANCES ANTICIPATED OR EXPECTED TO BE JUNIOR TO THIS LOAN *(SEE PART 8)* $	PROTECTIVE EQUITY (MARKET VALUE MINUS THIS LOAN AND TOTAL SENIOR ENCUMBRANCES) $	TOTAL LOAN TO VALUE (SEE PART 10G) %

PART 1 BROKER INFORMATION

NAME OF BROKER	REAL ESTATE LICENSE ID#
BUSINESS ADDRESS	TELEPHONE NUMBER
NAME OF BROKERS REPRESENTATIVE	

PART 2 BROKER CAPACITY IN TRANSACTION

THE BROKER IDENTIFIED IN PART 1 OF THIS STATEMENT IS ACTING IN THE FOLLOWING CAPACITY IN THIS TRANSACTION: (CHECK AS APPLIES)

☐ A. Agent in arranging a loan on behalf of another

☐ B. Principal as a borrower of funds from which broker will directly or indirectly benefit other than through the receipt of commissions, fees and costs and expenses as provided by law for services as an agent.

☐ C. Funding a portion of this loan. *(Multi-lender transactions are subject to Business and Professions Code Section 10229.)*

IF MORE THAN ONE CAPACITY HAS BEEN CHECKED PROVIDE EXPLANATION HERE.

IF "B" HAS BEEN CHECKED, THE BROKER INTENDS TO USE FUNDS FROM THE LENDER/PURCHASER IN THIS TRANSACTION FOR:

PART 3 TRANSACTION INFORMATION

TERM OF LOAN	PRIORITY OF THIS LOAN (1ST, 2ND, ETC.)	PRINCIPAL AMOUNT $	YOUR SHARE IF MULTI-LENDER TRANS. $
INTEREST RATE % ☐ VARIABLE ☐ FIXED	(CHECK ONE) ☐ AMORTIZED ☐ PARTIALLY AMORTIZED	☐ INTEREST ONLY	***THE TRUST DEED WILL BE RECORDED.***
PAYMENT FREQUENCY ☐ MONTHLY ☐ WEEKLY	APPROXIMATE PAYMENT DUE DATE	AMOUNT OF PAYMENT $	YOUR SHARE IF MULTI-LENDER TRANS. $
BALLOON PAYMENT ☐ YES ☐ NO	APPROX. BALLOON PAYMENT DUE DATE	AMOUNT OF BALLOON PAYMENT $	YOUR SHARE IF MULTI-LENDER TRANS. $

Balloon Payment — A balloon payment is any installment payment (usually the payment due at maturity) which is greater than twice the amount of the smallest installment payment under the terms of the promissory note or sales contract.

The borrower/vendee may have to obtain a new loan or sell the property to make the balloon payment. If the effort is not successful it may be necessary for the holder of the note/contract to foreclose on the property as a means of collecting the amount owed.

There are subordination provisions. .... ☐ Yes ☐ No

If YES, explain here or on an attachment.

PART 4 MULTI-LENDER TRANSACTIONS

NAME OF ESCROW HOLDER	ANTICIPATED CLOSING DATE
ADDRESS OF ESCROW HOLDER	

ESTIMATED LENDER COSTS		ESTIMATED BORROWER COSTS — *Broker will provide you a copy of the "mortgage loan disclosure statement" given to the borrower or a separate itemization of borrower's costs.*
______	$ ______	
______	$ ______	
______	$ ______	
TOTAL	$ ______	TOTAL $ ______

Servicing

You will be a joint beneficiary with others on this note and you should request a list of names and addresses of the beneficiaries as of the close of escrow from the broker or servicing agent. The beneficiary(ies) holding more than 50% interest in the note may govern the actions to be taken on behalf of all holders in the event of default or other matters. See Civil Code Section 2941.9.

Loan To Value

GENERALLY the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the real property senior thereto, shall not exceed the following percentages of the current market value of the real property as determined in writing by the broker or qualified appraiser.

Single–family residence, owner–occupied 80%

Single–family residence, not owner–occupied 75%

Commercial and income–producing properties 65%

Single-family residentially zoned lot or parcel which has installed off-site improvements including drainage, curbs, gutters, sidewalks, paved roads, and utilities as mandated by the political subdivision having jurisdiction over the lot or parcel 65%

Land which has been zoned for (and if required, approved for subdivision as) commercial or Residential development 50%

Other real property 35%

The percentage amounts specified above may be exceeded when and to the extent that the broker determines that the encumbrance of the property in excess of these percentages is reasonable and prudent considering all relevant factors pertaining to the real property. However, in no event shall the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the property senior thereto, exceed 80 percent of the current fair market value of improved real property or 50 percent of the current fair market value of unimproved real property, except in the case of a single-family residentially zoned lot or parcel as defined above, which shall not exceed 65% of current fair market value of that lot or parcel. A written statement shall be prepared by the broker that sets forth the material considerations and facts that the broker relies upon for his or her determination which shall be disclosed to the lender or note purchaser(s) and retained as a part of the broker's record of the transaction.

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PART 5 SERVICING ARRANGEMENTS

If the loan is to be serviced by a real estate broker you must be notified within ten (10) days if the broker makes any advances on senior encumbrances to protect the security of your note. Depending on the terms and conditions of the servicing contract, you may be obligated to repay any such advances made by the broker. (Note: There must be a servicing agent on multi-lender transactions.) The broker may not guarantee or imply to guarantee, or advance any payments to you unless a securities permit is obtained from the Department of Corporations.

CHECK APPROPRIATE STATEMENTS

☐ THERE ARE NO SERVICING ARRANGEMENTS *(Does not apply to multi-lender transactions.)*
☐ BROKER IS THE SERVICING AGENT
☐ ANOTHER QUALIFIED PARTY WILL SERVICE THE LOAN
☐ COPY OF THE SERVICING CONTRACT IS ATTACHED

IF BROKER IS NOT SERVICING AGENT, WHAT IS THE RELATIONSHIP BETWEEN THE BROKER AND SERVICER?	COST TO LENDER FOR SERVICING ARRANGEMENTS *(EXPRESS AS DOLLAR AMOUNT OR PERCENTAGE)* *PER* ☐ MONTH ☐ YEAR ☐ *PAYABLE* ☐ MONTHLY ☐ ANNUALLY ☐

NAME OF AUTHORIZED SERVICER, IF ANY

BUSINESS ADDRESS	TELEPHONE NUMBER

PART 6 BORROWER INFORMATION

SOURCE OF INFORMATION

☐ BORROWER ☐ BROKER INQUIRY ☐ CREDIT REPORT ☐ OTHER (DESCRIBE)

NAME		CO-BORROWER'S NAME	
RESIDENCE ADDRESS		CO-BORROWER'S RESIDENCE ADDRESS	
OCCUPATION OR PROFESSION		CO-BORROWER'S OCCUPATION OR PROFESSION	
CURRENT EMPLOYER		CO-BORROWER'S CURRENT EMPLOYER	
HOW LONG EMPLOYED?	AGE	HOW LONG EMPLOYED?	CO-BORROWER'S AGE

SOURCES OF GROSS INCOME *(LIST AND IDENTIFY EACH SOURCE SEPARATELY.)*	MONTHLY AMOUNT	CO-BORROWER SOURCES OF GROSS INCOME (LIST AND IDENTIFY EACH SOURCE SEPARATELY.)	MONTHLY AMOUNT
Gross Salary	$	Gross Salary	$
OTHER INCOME INCLUDING: Interest	$	*OTHER INCOME INCLUDING:* Interest	$
Dividends	$	Dividends	$
Gross Rental Income	$	Gross Rental Income	$
Miscellaneous Income	$	Miscellaneous Income	$

TOTAL EXPENSES OF ALL BORROWERS ***(DO NOT COMPLETE IF BORROWER IS A CORPORATION)***

Payment of Loan being obtained	$	Spousal/Child Support	$
Rent	$	Insurance	$
Charge Account/Credit Cards	$	Vehicle Loan(s)	$
Mortgage Payments *(include taxes and property insurance)*	$	Other *(federal & state income taxes, etc.)*	$

TOTAL GROSS MONTHLY INCOME OF BORROWER(S)	TOTAL MONTHLY EXPENSES OF BORROWER(S)
$	$

The borrower has filed for bankruptcy in the past 12 months. ☐ Yes ☐ No

If Yes, the bankruptcy has been discharged or dismissed. ☐ Yes ☐ No

■ ***THE FOLLOWING STATEMENTS ONLY APPLY IF THE BORROWER IS A CORPORATION, PARTNERSHIP OR SOME OTHER FORM OF OPERATING BUSINESS ENTITY.***

Copies of a balance sheet of the entity and income statement covering the indicated period have been supplied by the borrower/obligor and are attached. If no, explain on addendum. ☐ Yes ☐ No

If yes, Date of balance sheet ____________

Income statement period *(from-to)* ____________

Financial Statements have been audited by CPA or PA. ☐ Yes ☐ No

Additional information is included on an attached addendum ☐ Yes ☐ No

PART 7 PROPERTY INFORMATION

Identification of property which is security for note. *(If no street address, the assessor's parcel number or legal description and a means for locating the property is attached.)*

STREET ADDRESS		OWNER OCCUPIED ☐ NO ☐ YES
ANNUAL PROPERTY TAXES $ ☐ ACTUAL ☐ ESTIMATED	ARE TAXES DELINQUENT? ☐ NO ☐ YES	IF YES, AMT. REQUIRED TO BRING CURRENT $
SOURCE OF TAX INFORMATION		

PART 8 APPRAISAL INFORMATION

Estimate of fair market is to be determined by an independent appraisal, copy of which must be provided to you prior to you obligating funds to make the loan. Note: You may waive the requirement of an independent appraisal, in writing, on a case by case basis, in which case the broker must provide a written estimate of fair market value. The broker must provide you, the investor, with the objective data upon which the broker's estimate is based.

FAIR MARKET VALUE (ACCORDING TO APPRAISER) $ *(Place this figure or brokers estimate of fair market value on line "F" of Part 9.)*		DATE OF APPRAISAL
NAME OF APPRAISER (IF KNOWN TO BROKER)		PAST AND/OR CURRENT RELATIONSHIP OF APPRAISER TO BROKER (EMPLOYEE, AGENT, INDEPENDENT CONTRACTOR, ETC.)
ADDRESS OF APPRAISER		
DESCRIPTION OF PROPERTY/IMPROVEMENT		IS THERE ADDITIONAL SECURING PROPERTY? ☐ YES IF YES, SEE ADDENDUM. ☐ NO
AGE	SQUARE FEET	TYPE OF CONSTRUCTION
IF THE PROPERTY IS CURRENTLY GENERATING INCOME FOR THE BORROWER/OBLIGOR: ESTIMATED GROSS ANNUAL INCOME $		ESTIMATED NET ANNUAL INCOME $

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PART 9 ENCUMBRANCE INFORMATION

Information concerning senior encumbrances against the property, to the extent reasonably available from customary sources (excluding the note described on page 1 Part 3). **Note:** You have the option to purchase a title insurance policy or an endorsement to an existing title insurance policy insuring your interest, and you are entitled to a copy of a written loan application and a credit report to obtain information concerning all encumbrances which constitute liens against the property. This information may help determine the financial standing and credit worthiness of the borrower.

SOURCE OF INFORMATION

☐ BROKER INQUIRY ☐ BORROWER ☐ OTHER *(EXPLAIN)*

Are there any encumbrances of record against the securing property at this time? .... ☐ YES ☐ NO

A. Over the last 12 months were any payments more than 60 days late? .... ☐ YES ☐ NO

B. If yes, how many? .... ______

C. Do any of these payments remain unpaid? .... ☐ YES ☐ NO

D. If yes, will the proceeds of subject loan be used to cure the delinquency? .... ☐ YES ☐ NO

E. If no, source of funds to bring the loan current. .... ______

Encumbrances remaining and/or expected or anticipated to be placed against the property by the borrower/obligor after the close of escrow (excluding the note described on page 1).

ENCUMBRANCE(S) REMAINING *(AS REPRESENTED BY THE BORROWER)*

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT $	APPROXIMATE PRINCIPAL BALANCE $	ORIGINAL AMOUNT $	APPROXIMATE PRINCIPAL BALANCE $
MONTHLY PAYMENT $	MATURITY DATE	MONTHLY PAYMENT $	MATURITY DATE
BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $	BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $

ENCUMBRANCES EXPECTED OR ANTICIPATED *(AS REPRESENTED BY THE BORROWER)*

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT $	MATURITY DATE	ORIGINAL AMOUNT $	MATURITY DATE
MONTHLY PAYMENT $		MONTHLY PAYMENT $	
BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $	BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $

Additional remaining, expected or anticipated encumbrances are set forth in an attachment to this statement. .... ☐ Yes ☐ No

PART 10 **LOAN TO VALUE RATIO**

A. Remaining encumbrances senior to this loan *(from part 8)* .... $____________

B. Encumbrances expected or anticipated senior to this loan *(from part 9)* .... + $____________

C. Total remaining and expected or anticipated encumbrances senior to this loan .... = $____________

D. Principal amount of this loan from page 1 part 3 .... + $____________

E. Total all senior encumbrances and this loan .... = $____________

F. Fair market value from page 4 part 8 .... ÷ $____________

G. Loan to value ratio .... = ____________%

Note: See Part 4 if multi-lender transaction.

BROKER VERIFICATION

The information in this statement and in the attachments hereto is true and correct to the best of my knowledge and belief.

SIGNATURE OF BROKER OR DESIGNATED REPRESENTATIVE	BROKER/CORPORATION ID#	DATE
➢		

ACKNOWLEDGMENT OF RECEIPT

The prospective lender/purchaser acknowledges receipt of a copy of this statement signed by or on behalf of the broker.

SIGNATURE OF PROSPECTIVE LENDER/PURCHASER	DATE
➢	

The DRE licensing information telephone number is (916) 227-0931.

INSURANCE LIMITATIONS

"CREDIT LIFE" AND "CREDIT DISABILITY" INSURANCE

This insurance pays off the loan if the insured dies and makes the payments if the Insured become disabled.

This type of insurance cannot be required as a condition for making the loan. However, the licensee may, with the borrower's consent, provide credit life and disability insurance through licensed insurance agents.

- Coverage may not be in an amount in excess of that reasonably necessary to discharge the obligation of the borrower.
- The form and rate must be approved by the Insurance Commissioner.
- The term of the policy may not exceed the length of the loan.

☞ ***The broker may not require as a condition of the loan, that the borrower purchase credit life insurance or credit disability insurance. business and Professions Code 10241.1)***

However, the lender can insist for self–protection and by the terms of the trust deed that **fire and hazard insurance** be obtained on improved property until the loan has been repaid. If licensed to sell such insurance, the loan broker may also act as the insurance agent for the borrower, but borrowers are not obligated to purchase the coverage through the mortgage loan broker. They may purchase insurance from their own insurance agent.

If the borrower elects to purchase such insurance coverage it must be in a form approved by the insurance commissioner and may not be in an amount in excess of what is required to pay off the loan. The licensee can only collect one premium on the loan even when there are multiple borrowers (only one borrower may be insured unless another borrower's wages are necessary to make the payments).

The licensee can collect the cost of fire and hazard insurance if the policy is payable to the borrower and it is sold at a standard rate through a licensed agent.

If insurance premiums are to be paid from the proceeds of this loan, the premium amount cannot be used to determine if the loan is exempt from limitations on cost and fees.

PREPAYMENT PENALTIES

☞ ***Prepayment penalties are not allowed on loans for owner–occupied dwellings after 7 years (a penalty can be charged within 7 years). (Business and Professions Code 10242.6)***

Twenty percent of the unpaid balance can be prepaid in any 12 month period without being subject to a prepayment penalty This means that the prepayment penalty would ordinarily only apply to 80% of the loan when it is prepaid.

BROKER CONTROLLED FUNDS

If a broker makes or arranges loans secured by real property and uses any broker controlled funds, the broker must advise the borrower of this fact not later than the business day following this decision but, in any event, prior to close of escrow. (Business and Professions Code 10241.2)

Broker controlled funds are funds owned by the broker, a spouse, child, parent, grandparent, brother, sister in–law or any entity in which the broker alone or with one of the above has a 10% or greater interest.

APPRAISAL REPORT COPY

If the borrower pays for an appraisal of real property, a copy of the appraisal report must be given to both the borrower and lender at or before closing the loan transaction. (Business and Professions Code 10241.3)

MAXIMUM ALLOWABLE CHARGES

COST AND CHARGES

The costs and expenses of a loan include appraisal fees. escrow fees, title charges, notary fees. recording fees and credit investigation fees.

Maximum costs for first trust deed under $30,000 and second trust deeds under $20,000 cannot exceed 5% of the loan or ***$390***, whichever is greater, but never more than ***$700.*** (Costs and expenses can never exceed actuals or reasonably earned costs and fees.) (Business and Professions Code 10242)

What the above paragraph means is that the minimum costs and fees will be $390 and the maximum will be $700 with the 5% applicable to numbers in between.

Broker's Commission

Mortgage loan brokers are regulated by law in the percentage amount of commissions that they may charge, as shown in table below.

The brokers commission is regulated for first trust deeds under $30,000 and second trust deeds under $20,000. Maximum commissions for applicable loans are outlined in table 10–1.

As the table shows, the shorter the term of the loan, the less commission the broker may charge as a percentage of the face amount of the loan. On loans of $30,000 and over for first liens, and $20,000 for junior liens, the broker may charge as much as the borrower agrees to pay. Even for loans covered by the law, however, competition frequently keeps the rates below the maximum allowed.

☞ ***There is of course no limit as to the commission that can be charged for first trust deeds of $30, 000 or more and second trust deeds of $20, 000 or more.***

Figure 10-1: Maximum Commissions

Type of Loan	Less Than Two Years	Two Years but Less Than Three	Three Years and Over	Exempt Transactions
First Trust Deeds	5 %	5%	10%	loans of $30,000 and over
Junior Trust Deeds	5%	10%	15%	loans of $20,000 and over

Figure 10-2 Maximum charges for other costs and expenses

Loan Amount	Under $7,801	$7,801 to $13,999	$14,000 to $29,999	First loans of $30,000 and

				over and junior loans of $20,000 and over
Maximum Charges	$390	5% of loan	$700	No legal limitations

☞ ***Example:***

1. $5,000 Loan

   5,000 x 5% = $250;

   But fees can be 5% or $390 whichever is greater $390 is greater than $250

2. $9,000 Loan

   9, 000 x 5% = $450

   But fees can be 5% or $390 whichever is greater $450 is greater than $390

3. $19,000 Loan

   19,000 x 5% = $950

   But fees can be 5% to a maximum of $700 so, the fee cannot exceed $700.

EQUAL PAYMENTS

- **Loans Under Three Years** – Loans secured by a lien on real property (other than a note given back to the seller by the buyer) which provide for installment payments over a term less than three years shall require equal payments over the loan period with the final payment not payable until the maturity date. (Business and Professions Code 10244)

☞ ***No installment, including the final payment, shall be greater than twice the amount of the smallest payment.***

The above paragraph really says that there can be no balloon payments on broker arranged loans for less than three years.

- **Loans Under 6 Years** – **Owner–occupied** – When the loan is for an owner–occupied dwelling, payments must be equal for loans under six years. No balloon payments for loans under six years. (Business and Professions Code 10244.1)

EXEMPT FROM THE MORTGAGE LOAN BROKER LAW

It is easier to state which lenders and what transactions are *not* covered by the law than to list those that are covered.

- **Regulated Institutional lenders**. – Purchase money transactions in which a seller carries back the loan as part of the sale price. However, if a seller is in the business of carrying back loans in eight or more transactions per year, the Mortgage loan Broker law does apply.
- Loans secured by first trust deeds when the principal amount is $30,000 or more.
- Loans secured by junior trust deeds when the principal amount is $20,000 or more.

OTHER PROVISIONS

Article 7 also addresses aspects of the licensee's role, liability, balloon and late payments, and insurance.

- **Exclusive Agreement** – An exclusive authorization to procure a loan requires a definite termination date and cannot exceed 45 days.
- **Licensee as lender** – A broker may lend the broker's own money, with written consent of the borrower. Since the passage of Proposition 2 in 1979, the licensed real estate broker is not limited to any maximum rate of interest for arranging or making a real estate loan. However, the broker is prohibited from imposing other charges if the broker is the lender. Full disclosure to the borrower is required.

BORROWER'S LIABILITY

If the loan is not consummated due to faulty title or borrower's failure to disclose liens, the borrower is liable for costs and expenses incurred, and one–half of the commission.

BALLOON PAYMENTS

As mentioned earlier any payment greater than ***"twice the amount of the smallest payment"*** in the loan schedule is a balloon payment. Usually a balloon payment describes the final payment owing when an amortized loan becomes due if this amount is more than twice the amount of the smallest installment.

Balloon payments are not allowed on:

- Any loan for less than 3 years
- A loan on an owner–occupied dwelling of less than 3 units for a term of 6 years or less.

This balloon payment limitation is not applicable to a purchase money note from seller to buyer on any real property transaction.

LATE PAYMENTS

No late charge is permitted if payment is made within **10 days** of due date. When a late charge is permitted, the following limits apply.

- The penalty is limited to 10% of the principal and interest portion of payment. A minimum charge of $5 can be assessed when the amount due is less than $50.

PYRAMIDING PROHIBITED

Only one charge can be made for a late payment. (If an earlier payment was not paid in full the lender cannot consider all future payments late because of the balance due off the partial or missed payment.)

Required Disclosures State Requirements

1. Mortgage Loan Disclosure Statement. (MLDS)
2. Fair Housing.
3. Lender Purchaser Disclosure Statement. (LPDS)
4. Home Mortgage Disclosure Act Reporting.
5. Seller Carryback Requirements.

Required Disclosures Federal Requirements

1. Truth In Lending.
2. Real Estate Settlement Procedures Act.
3. Equal Credit Opportunity Act.
4. Transfer Disclosure.
5. Written Authorization to Run Credit Report.

☞ ***Disclosure is not required if the licensee is negotiating the loan for a "controlled" institution (regulated by law, i.e., banks, savings and loans) and the commission does not exceed 2% of the loan.***

Good Faith Estimate RE Form 883

RE 883 includes the Good Faith Estimate required by RESPA as well as additional California required disclosures.

Applicability of Real Estate Law

Provisions of the real estate license law do not apply to any employee of a regulated bank, trust company, savings and loan association, industrial loan company, pension trust, credit union, or insurance company.

COMMUNITY REINVESTMENT ACT (CRA)

To guarantee fair tending practices, Congress passed the CRA, which requires all federally supervised financial institutions (thrifts, commercial banks, credit unions, etc.) to disclose lending data in their lobbies and elsewhere. Lenders are required to report data regarding the race, gender, income, and census tract of people to whom they make loans. Its stated purpose is **"**to assist in identifying discriminatory practices and enforcing anti–discrimination statutes.**"** CRA encourages lenders to offer mortgages for low– and moderately priced housing and meet other credit needs for low– and moderate–income families. The basic idea is that if an institution accepts deposits from a certain area, it should also offer loans in that area.

CRA ratings are made public for all banks and ***thrift institutions.*** The government grades each institution on how well it

- Knows the credit needs of its community
- Informs the community about its credit services
- Involves its directors in setting up and monitoring CRA programs
Participates in government–insured, guaranteed, or subsidized loans
- Distributes credit applications, approvals, and rejections across geographic areas
- Offers a range of residential mortgages, housing rehabilitation loans, and small business loans

All of these criteria are designed to protect consumers against unlawful discrimination. A positive CRA rating is a prerequisite for institutions to open new branches and to engage in expansions, acquisitions, and mergers, since outside third parties can petition agencies to deny these activities to institutions with poor CRA grades.

Form 10-1: Good Faith Estimate Disclosure (RE 883)

STATE OF CALIFORNIA

DEPARTMENT OF REAL ESTATE
MORTGAGE LENDING

MORTGAGE LOAN DISCLOSURE STATEMENT/GOOD FAITH ESTIMATE

RE 883 (New 12/93)

Borrower's Name(s): ____

Real Property Collateral: The intended security for this proposed loan will be a Deed of Trust on (street address or legal description) ____

This joint Mortgage Loan Disclosure Statement/Good Faith Estimate is being provided by ______________________ , a real estate broker acting as a mortgage broker, pursuant to the Federal Real Estate Settlement Procedures Act (RESPA) and similar California law. In a transaction subject to RESPA, a lender will provide you with an additional Good Faith Estimate within three business days of the receipt of your loan application. You will also be informed of material changes before settlement/close of escrow. The name of the intended lender to whom your loan application will be delivered is:

☐ Unknown ☐ ______________________________ (Name of lender, if known)

GOOD FAITH ESTIMATE OF CLOSING COSTS

The information provided below reflects estimates of the charges you are likely to incur at the settlement of your loan. The fees, commissions, costs and expenses listed are estimates; the actual charges may be more or less. Your transaction may not involve a charge for every item listed and any additional items charged will be listed. The numbers listed beside the estimate generally correspond to the numbered lines contained in the HUD-1 Settlement Statement which you will receive at settlement if this transaction is subject to RESPA. The HUD-1 Settlement Statement contains the actual costs for the items paid at settlement. When this transaction is subject to RESPA, by signing page two of this form you are also acknowledging receipt of the HUD Guide to Settlement Costs.

HUD-1	Item	Paid to Others	Paid to Broker
800	***Items Payable in Connection with Loan***		
801	Lender's Loan Origination Fee	$ ________	$ ________
802	Lender's Loan Discount Fee	$ ________	$ ________
803	Appraisal Fee	$ ________	$ ________
804	Credit Report	$ ________	$ ________
805	Lender's Inspection Fee	$ ________	$ ________
808	Mortgage Broker Commission/Fee	$ ________	$ ________
809	Tax Service Fee	$ ________	$ ________
810	Processing Fee	$ ________	$ ________
811	Underwriting Fee	$ ________	$ ________
812	Wire Transfer Fee	$ ________	$ ________
____	________________	$ ________	$ ________
900	***Items Required by Lender to be Paid in Advance***		
901	Interest for ____ days at $_______ per day	$ ________	$ ________
902	Mortgage Insurance Premiums	$ ________	$ ________
903	Hazard Insurance Premiums	$ ________	$ ________
904	County Property Taxes	$ ________	$ ________
905	VA Funding Fee	$ ________	$ ________
____	________________	$ ________	$ ________
1000	***Reserves Deposited with Lender***		
1001	Hazard Insurance: ____ months at $_______ /mo.	$ ________	$ ________
1002	Mortgage Insurance: ____ months at $_______ /mo.	$ ________	$ ________
1004	Co. Property Taxes: ____ months at $_______ /mo.	$ ________	$ ________
____	________________	$ ________	$ ________
1100	***Title Charges***		
1101	Settlement or Closing/Escrow Fee	$ ________	$ ________
1105	Document Preparation Fee	$ ________	$ ________
1106	Notary Fee	$ ________	$ ________
1108	Title Insurance	$ ________	$ ________
____	________________	$ ________	$ ________
1200	***Government Recording and Transfer Charges***		
1201	Recording Fees	$ ________	$ ________
1202	City/County Tax/Stamps	$ ________	$ ________
____	________________	$ ________	$ ________
1300	***Additional Settlement Charges***		
1302	Pest Inspection	$ ________	$ ________
____	________________	$ ________	$ ________

Subtotals of Initial Fees, Commissions, Costs and Expenses $ ________ $ ________

Total of Initial Fees, Commissions, Costs and Expenses $ ________

Compensation to Broker (Not Paid Out of Loan Proceeds):

Mortgage Broker Commission/Fee $ ________

Any Additional Compensation from Lender ☐ No ☐ Yes $ ________ (if known)

Page 1 of 2

ADDITIONAL REQUIRED CALIFORNIA DISCLOSURES

I. Proposed Loan Amount: $______________

Initial Commissions, Fees, Costs and Expenses Summarized on Page 1: $ ____________

Payment of Other Obligations (List):

Credit Life and/or Disability Insurance (see VI below) $ ____________

____________________________ $ ____________

____________________________ $ ____________

Subtotal of All Deductions: $______________

Estimated Cash at Closing ☐ **To You** ☐ **That you must pay** $______________

II. Proposed Interest Rate: ________% ☐ Fixed Rate ☐ Initial Variable Rate

III. Proposed Loan Term: __________ ☐ Years ☐ Months

IV. Proposed Loan Payments: Payments of $__________ will be made ☐ Monthly ☐ Quarterly ☐ Annually for ______ (number of months, quarters or years). If proposed loan is a variable interest rate loan, this payment will vary (see loan documents for details).

The loan is subject to a balloon payment: ☐ No ☐ Yes. If Yes, the following paragraph applies and a final balloon payment of $_________ will be due on ___/___/___ *[estimated date (day/month/year)].*

NOTICE TO BORROWER: IF YOU DO NOT HAVE THE FUNDS TO PAY THE BALLOON PAYMENT WHEN IT COMES DUE, YOU MAY HAVE TO OBTAIN A NEW LOAN AGAINST YOUR PROPERTY TO MAKE THE BALLOON PAYMENT. IN THAT CASE, YOU MAY AGAIN HAVE TO PAY COMMISSIONS, FEES, AND EXPENSES FOR THE ARRANGING OF THE NEW LOAN. IN ADDITION, IF YOU ARE UNABLE TO MAKE THE MONTHLY PAYMENTS OR THE BALLOON PAYMENT, YOU MAY LOSE THE PROPERTY AND ALL OF YOUR EQUITY THROUGH FORECLOSURE. KEEP THIS IN MIND IN DECIDING UPON THE AMOUNT AND TERMS OF THIS LOAN.

V. Prepayments: The proposed loan has the following prepayment provisions.

☐ No prepayment penalty.
☐ Other (see loan documents for details).
☐ Any payment of principal in any calendar year in excess of 20% of the ☐ original balance ☐ unpaid balance will include a penalty not to exceed ______ months advance interest at the note rate, but not more than the interest that would be charged if the loan were paid to maturity (see loan documents for details).

VI. Credit Life and/or Disability Insurance: The purchase of credit life and/or disability insurance by a borrower is NOT required as a condition of making this proposed loan.

VII. Other Liens: Are there liens currently on this property for which the borrower is obligated? ☐ No ☐ Yes
If Yes, describe below:

Lienholder's Name	*Amount Owing*	*Priority*

Liens that will remain or are anticipated on this property after the proposed loan for which you are applying is made or arranged (including the proposed loan for which you are applying):

Lienholder's Name	*Amount Owing*	*Priority*

NOTICE TO BORROWER: Be sure that you state the amount of all liens as accurately as possible. If you contract with the broker to arrange this loan, but it cannot be arranged because you did not state these liens correctly, you may be liable to pay commissions, costs, fees, and expenses even though you do not obtain the loan.

VIII. Article 7 Compliance: If this proposed loan is secured by a first deed of trust in a principal amount of less than $30,000 or secured by a junior lien in a principal amount of less than $20,000, the undersigned licensee certifies that the loan will be made in compliance with Article 7 of Chapter 3 of the Real Estate Law.

A. This loan ☐ may ☐ will ☐ will not be made wholly or in part from broker controlled funds as defined in Section 10241(j) of the Business and Professions Code.

B. If the broker indicates in the above statement that the loan "may" be made out of broker-controlled funds, the broker must inform the borrower prior to the close of escrow if the funds to be received by the borrower are in fact broker-controlled funds.

_______________________________ _______________________________
Name of Broker *License #* *Broker's Representative* *License #*

____
Broker's Address

_______________________________ OR _______________________________
Signature of Broker *Date* *Signature of Representative* *Date*

IX. NOTICE TO BORROWER: THIS IS NOT A LOAN COMMITMENT. Do not sign this statement until you have read and understood all of the information in it. All parts of this form must be completed before you sign. Borrower hereby acknowledges the receipt of a copy of this statement.

_______________________________ _______________________________
Borrower *Date* *Borrower* *Date*

Review completed on ____________ by ____________________________ ____________________
Date *Broker or Designated Representative* *Dept. of Real Estate License #*

CHAPTER QUIZ

1. Article 5 of the real estate law does NOT apply to:

   A. Licensed real estate brokers
   B. Broker loans arranged as part of a sale
   C. Brokers who make fewer than 20 loans per year
   D. All of the above

2. A mortgage loan broker, without authorization to the contrary, cannot retain funds received for a loan payment for more than:

   A. 24 hours
   B. 7 days
   C. 30 days
   D. 60 days

3. A broker may not advertise a yield different than the rate of the note:

   A. Under any circumstances
   B. Unless a permit was issued by the DRE
   C. Unless the rate of the note and discount are stated
   D. Unless the broker has put up a $10,000 bond

4. In servicing a loan, a broker used her own funds to remit a note to an owner when a purchaser was late on a payment. The broker:

   A. Has placed her license in jeopardy
   B. Must be licensed by the Department of Corporations to advance funds
   C. Must give written notice to the lender within 10 days of making the payment
   D. Has 7 days to notify the Department of Corporations

5. A broker released funds prior to close of a loan transaction and recording the deed. The broker should deliver the deed to the lender with the recommendation of recording or record it within:

   A. 24 hours of release of funds
   B. 3 days of release of funds
   C. 10 days of release of funds
   D. 60 days of release of funds

6. Exempt under the Real Property Loan law are

A. First trust deeds of under $30,000.
B. Second trust deeds of under $20,000.
C. Purchase money loans carried back by sellers.
D. Loans maturing in more than six years.

7. Which of the following loans would a broker NOT be limited as to commission or loan costs?

A. A first trust deed for $10,000
B. A second trust deed for $20,000
C. Both A and B
D. Neither A nor B

8. The maximum loan costs that can be charged for a $10,000 second trust deed would be:

A. 15% of the loan
B. $390
C. $500
D. $700

9. The law specifically governing the activities of loan brokers is called the

A. Real Estate law.
B. Real Property Loan law.
C. Mortgage loan Disclosure law.
D. Real Property Securities Act.

10. An annual report from a loan broker to the Commissioner:

A Is required of all loan brokers
B Involves a CPA's audit of the loan broker's trust fund accounts
C Is required only of brokers doing a certain minimum volume and dollar amount of business
D Both B and C

Answers: 1–B, 2–D, 3–C, 4–C, 5–C, 6–B, 7–B, 8–B, 9–B, 10–C

CHAPTER 11: FINANCING DISCLOSURE REQUIREMENTS

PREVIEW

When a real estate mortgage broker acts as a lender or on behalf of a lender, he/she must be in compliance with all applicable regulations. In doing so, however, brokers find that conflicts occur between federal law and state law.

At a federal level, the Consumer Credit Protection Act and the Federal Truth–in–Lending Act, are the two regulations most frequently dealt with. For California, both the California Department of Corporation (DOC) and Department of Real Estate (DRE) regulations oversee the activities of lenders, including laws found in both the Business Professions Code and the California real estate law.

TRUTH IN LENDING ACT / REGULATION Z

Truth–in–Lending is the name used in referring to Regulation Z issued by the Federal Reserve Board under the Consumer Credit Protection Act of 1969. The Federal Trade Commission enforces this law for business firms.

The purpose of the law is to help a borrower understand how much it is costing to borrow money. Each lender is required to show its costs in the same way, so borrowers can compare one lender against the other. The tool that is used to compare one loan against another is called the ***annual percentage rate (APR).***

The APR is not an interest rate. It is a simple way of informing a borrower of the "effective" rate of interest.

☞ ***APR is the cost of credit expressed as a yearly rate.***

Accuracy of the APR must be within one–eight of one percent of the actual annual rate for a normal transaction. In irregular transactions, such as where there are multiple advances of funds or irregular payment periods or amount, accuracy must be within one–fourth of one percent of the rate determined to be the actual annual rate.

To arrive at the total cost, you add not only the total interest paid but various other charges the borrower pays as permitted by statute.

APPLICATION

The purpose of Regulation Z is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. The regulation also gives consumers the right to cancel certain credit transactions that involve a lien on a consumer's principal dwelling. The regulation does not govern or limit charges for consumer credit; it only requires disclosure.

- **Creditor** – Under this act, a "creditor" is a person or firm who extends consumer credit more than 25 times a year or more than 5 times a year for transactions secured by dwellings. This does not include persons such as brokers who merely arrange credit from lenders. The effect of this is to exempt real estate brokers from the responsibility of providing "Truth in Lending" disclosures unless they are themselves acting as "creditors."

- **Application to Real Estate** – Regulation Z affects "creditors" who offer or extend credit for real estate loans to a natural person for personal, family, or household uses, which are payable in more than four installments or for which a finance charge is made.

- **Institutions** – The law applies to banks, savings and loan associations, credit unions, consumer finance companies, and residential loan mortgage brokers.

- **Advertising** – Since October 1, 1982, Regulation Z has applied to all credit advertising of anyone, not just "creditors."

- **Exempt Transactions** – In general, transactions which do not involve "consumer" credit are not subject to Regulation Z.

- Loans to organizations and governments for business, commercial, or agricultural purposes.
- Non–real estate credit transactions over $25,000.
- A loan on borrower's personal residence if the loan is for business use. Includes building a "home office" for business purposes.

Disclosure Requirements

A **"creditor"** must furnish the borrower with a Federal Real Estate Loan Disclosure Statement, which must include:

- **Amount Financed** – The total amount of "credit extended" (frequently less than the face amount of the note).
- **Itemization of Amount Financed** – Explanation of additional charges such as appraisal, credit reports, recording, etc. Need not be repeated when estimates of settlement costs have been supplied under RESPA.
- **Finance Charge** – The total dollar amount that the credit will cost. Included in the finance charge are:
    - Interest
    - Loan fees, assumption fees, finder's fees, and buyer's points
    - Premiums for mortgage–guarantee or similar insurance
    - Loan broker's commission
- **Not included in finance charge** in a transaction secured by real property:
    - Points paid by seller
    - Fees for title examination, abstract of title, title insurance, property survey, and similar services
    - Fees for preparing deeds, mortgages, and reconveyance, settlement, and similar documents
    - Notary, appraisal, and credit report fees

- **Annual Percentage Rate (APR)** – Relationship between the total finance charge and the total amount financed, expressed as a percentage.
- **Payment Schedule** – The number, amounts, and timing of payments.
- **Total of Payments** – The total amount borrower will have paid at the end of the loan period. Total of payments minus amount financed equals finance charge.
- **Other Items** – Such as late payment charges, prepayment penalties, balloon payment, demand feature, lender's assumption policy, and the security interest retained in the property.
- **Variable Rate** – For closed–end adjustable rate mortgages (ARMs) there are new special requirements. These are explained in detail in Chapter 8.

Right To Cancel

A borrower has the right to rescind before midnight of the third business day following consummation of contract, when the security for a loan is real property which is the principal residence of the borrower.

- **Exempt Transactions** – The right to cancel does not apply to:
    - Any mortgage/trust deed used to finance acquisition or construction of a dwelling, or the assumption of such a mortgage, and
    - Refinancing by the original creditor, "if the original creditor only finances nonfinance charges such as attorney's fees, title examination fees, and insurance premiums" (1986 Federal Reserve Board Ruling).
- **Failure to Give Notice** – If notice of the right to rescind is not given, the borrower has three years to rescind, or until the property is transferred, whichever is less. The *Notice of Right to Cancel* explains the borrower's rights and complies with this requirement.

Form 11-1: Notice of Right to Cancel (CAR NRC–11)

____
(Creditor)

____
(Office)

____
(City)

NOTICE OF RIGHT TO CANCEL

CALIFORNIA ASSOCIATION OF REALTORS® STANDARD FORM

Name(s) of Customer(s) _______________

Type of Loan _______________

Amount of Loan _______________ $ _______________

Notice to Customer Required By Federal Law:

You have entered into a transaction on _______________, 19_____ which may result in a lien, mortgage, or other security interest on your home. You have a legal right under federal law to cancel this transaction, if you desire to do so, without any penalty or obligation within three business days from the above date or any later date on which all material disclosures required under the Truth in Lending Act have been given to you. If you so cancel the transaction, any lien, mortgage, or other security interest on your home arising from this transaction is automatically void. You are also entitled to receive a refund of any downpayment or other consideration if you cancel.

If you decide to cancel this transaction you may do so by notifying:

____
(Name of Creditor)

at _______________
(Address of Creditor's Place of Business)

by mail or telegram sent not later than midnight of _______________, 19_____.
(Date 3 business days after date of receipt of this notice.)

You may also use any other form of written notice identifying the transaction if it is delivered to the above address not later than that time. This notice may be used for that purpose by dating and signing below.

I hereby cancel this transaction.

_______________, 19_____ (Date)

_______________ (Customer's Signature)

____

ACKNOWLEDGEMENT OF RECEIPT

I hereby acknowledge receipt of TWO copies of the foregoing Notice of Right to Cancel.

_______________, 19_____ (Date)

_______________ (Customer's Signature)

_______________ (All joint owners must sign)

See reverse side for important information about your right of rescission.

To order, contact—California Association of Realtors®
525 S. Virgil Avenue, Los Angeles, California 90020

FORM NRC-11

EFFECT OF RESCISSION

When a customer exercises his right to rescind, he is not liable for any finance or other charge, and any security interest becomes void upon such a rescission. Within 10 days after receipt of a notice of rescission, the creditor shall return to the Customer any money or property given as earnest money, down payment, or otherwise, and shall take any action necessary or appropriate to reflect the termination of any security' interest created under the transaction. If the creditor has delivered any property to the customer, the customer may retain possession of it. Upon the performance of the creditor's obligations under this section, the customer shall tender the property to the creditor, except that if return of the property in kind would be impracticable or inequitable. the customer shall tender its reasonable value. Tender shall be made at the location of the property or at the residence of the customer, at the option of the customer. If the creditor does not take possession of the property within 10 days after tender by the Customer, Ownership of the property vests in the customer without obligation on his part to pay for it.

NOTICE OF INTENT TO PROCEED

I hereby certify that I have elected not to cancel or rescind the transaction referred to on the reverse side and that I have not delivered, mailed or filed for transmission by telegram to the Creditor any notice of cancellation or rescission of that transaction.

______________________________ 20 ______
Date and mail or deliver no sooner than 3 business days after date of receipt.

______________________________ 20 ______
Customer’s Signature

______________________________ 20 ______
(All joint owners must sign)

11: FINANCING DISCLOSURE REQUIREMENTS

ADVERTISING

In order to insure "truth in lending," no real estate advertising of a creditor or real estate licensee containing credit information shall state:

- The rate of a finance charge ("interest rate") unless stated as Annual Percentage Rate. (The abbreviation "APR" may be used.)
- Credit terms unless all of the following are stated:
  - Cash price
  - Amount of loan to be extended
  - Required "cash down payment," or statement that none is required
  - Number, amount, and due dates of all payments
  - Annual Percentage Rate
  - Total of all payments over the term of the loan.

PENALTIES

Violators of the Truth in Lending law are subject to:

- Up to $5,000 fine and a year in prison
- Damages payable to borrower for twice the finance charge (not less than $100, nor more than $1,000)

HOW TO CALCULATE APR

To understand how the APR is calculated, let's take a simple example.

☞ ***Example:***

Assume you go to a bank and borrow $1,000 for one year at 15% interest. At the end of the year, you pay back the $1,000 plus $150 in interest. The APR is the same as the interest rate calculated as follows:

APR = Interest / Money received = $150 / $1,000 = 15%

If the bank collected a $50 service charge in advance, you would receive $950, not $1,000. Therefore, you would have the use of $950 for one year, not $1,000. The APR would be calculated as follows:

Interest + Service charge / Money received = $200 / $950 = 21%

Under the Truth–in–lending law, there are several important terms. A *prepaid finance charge* is a charge paid separately or withheld from the proceeds of the loan. In real estate transactions, prepaid finance charges include loan origination fees, prepaid interest, tax service fee, and premiums for mortgage insurance protecting the lender, such as FHA or private mortgage insurance. The *finance charge* is the cost of the loan to the borrower. It is calculated by adding the interest paid over the life of the loan to the prepaid finance charge. The *amount financed* is the amount of the loan less the prepaid finance charges.

If we applied these terms to the previous example, it would look like this:

☞***APR = Finance charge / Amount financed = (Interest + Prepaid finance charge) / (Loan amount – Prepaid finance charge)***

Besides stating the APR, the disclosure statement must also provide other information on the loan. This includes information on the prepayment penalty, if any; late charges; and a three–day right of rescission in the case of refinancing and junior loans on a principal dwelling. The right of a borrower to observe this three–day right of recission may be waived, unless it is lender policy not to allow the waiver. If the lender does allow it, the reason generally acceptable is "financial hardship."

Form 11-1 Mortgage Loan Disclosure Statement (3 pages)

CALIFORNIA ASSOCIATION OF REALTORS®

MORTGAGE LOAN DISCLOSURE STATEMENT (BORROWER)

(As required by the Business and Professions Code §10241 and Title 10, California Administrative Code, §2840)

____
(Name of Broker/Arranger of Credit)

____
(Business Address of Broker)

I. **SUMMARY OF LOAN TERMS**

A. PRINCIPAL AMOUNT . . . . $ __________

B. ESTIMATED DEDUCTIONS FROM PRINCIPAL AMOUNT

1. Costs and Expenses (Paragraph III-A) . . . . $ __________
* 2. Broker Commission/Organization Fee (See Paragraph III-B) . . . . $ __________
3. Lender Origination Fee/Discounts (See Paragraph III-B) . . . . $ __________
4. Additional compensation will/may be received from lender not deducted from loan proceeds.
☐ YES $ __________ (if known) ☐ NO
5. Amount to be Paid on Authorization of Borrower (See Paragraph III) . . . . $ __________

C. ESTIMATED CASH PAYABLE TO BORROWER (A less B) . . . . $ __________

II. **GENERAL INFORMATION ABOUT LOAN**

A. If this loan is made, Borrower will be required to pay the principal and interest at __________ % per year, payable as follows: __________ (number of payments) ☐ monthly ☐ quarterly ☐ annually payments of $ __________ and a **FINAL/BALLOON** payment of $ __________ to pay off the loan in full.

NOTICE TO BORROWER: IF YOU DO NOT HAVE THE FUNDS TO PAY THE BALLOON PAYMENT WHEN IT COMES DUE, YOU MAY HAVE TO OBTAIN A NEW LOAN AGAINST YOUR PROPERTY TO MAKE THE BALLOON PAYMENT. IN THAT CASE, YOU MAY AGAIN HAVE TO PAY COMMISSIONS, FEES AND EXPENSES FOR THE ARRANGING OF THE NEW LOAN. IN ADDITION, IF YOU ARE UNABLE TO MAKE THE MONTHLY PAYMENTS OR THE BALLOON PAYMENT, YOU MAY LOSE THE PROPERTY AND ALL OF YOUR EQUITY THROUGH FORECLOSURE. KEEP THIS IN MIND IN DECIDING UPON THE AMOUNT AND TERMS OF THIS LOAN.

B. This loan will be evidenced by a promissory note and secured by a deed of trust on property identified as (street address or legal description):

____

C. 1. Liens presently against this property (do not include loan being applied for):

Nature of Lien	Priority	Lienholder's Name	Amount Owing

2. Liens that will remain against this property after the loan being applied for is made or arranged (include loan being applied for):

Nature of Lien	Priority	Lienholder's Name	Amount Owing

NOTICE TO BORROWER: Be sure that you state the amount of all liens as accurately as possible. If you contract with the broker to arrange this loan, but it cannot be arranged because you did not state these liens correctly, you may be liable to pay commissions, fees and expenses even though you do not obtain the loan.

REVISION DATE 10/2000
MS-11 (PAGE 1 OF 3)

Borrower acknowledges receipt of copy of this page.
Borrower's Initials (________)(________)

Reviewed by
Broker or Designee __________ Date__________

EQUAL HOUSING OPPORTUNITY

MORTGAGE LOAN DISCLOSURE STATEMENT (MS-11 PAGE 1 OF 3)

Property Address: ______________________________ Date: __________

D. If Borrower pays all or part of the loan principal before it is due, a PREPAYMENT PENALTY computed as follows may be charged:

____

____

____

E. Late Charges: ☐ YES, see loan documents or ☐ NO

F. The purchase of credit life or credit disability insurance by a borrower is not required as a condition of making this loan.

G. Is the real property which will secure the requested loan an "owner-occupied dwelling?" ☐ YES _____ or ☐ NO _____
(Borrower initial opposite YES or NO)

An "owner-occupied dwelling" means a single dwelling unit in a condominium or cooperative or residential building of four or fewer separate dwelling units, one of which will be owned and occupied by a signatory to the mortgage or deed of trust for this loan within 90 days of the signing of the mortgage or deed of trust.

III. DEDUCTIONS FROM LOAN PROCEEDS

A. Estimated Maximum Costs and Expenses of Arranging the Loan to be Paid Out of Loan Principal:

	PAYABLE TO	
	Broker	**Others**
1. Appraisal fee	________	________
2. Escrow fee	________	________
3. Title insurance policy	________	________
4. Notary fees	________	________
5. Recording fees	________	________
6. Credit investigation fees	________	________
7. Other costs and expenses:		
________	________	________
________	________	________

Total Costs and Expenses . . . . $ ________

* B. Compensation . . . . $ ________
1. Brokerage Commission/Origination Fee . . . . $ ________
2. Lender Origination Fee/Discounts . . . . $ ________

C. Estimated Payment to be Made out of Loan Principal on Authorization of Borrower

	PAYABLE TO	
	Broker	**Others**
1. Fire or other hazard insurance premiums	________	________
2. Credit life or disability insurance premiums (see Paragraph II-F)	________	________
3. Beneficiary statement fees	________	________
4. Reconveyance and similar fees	________	________
5. Discharge of existing liens against property:		
________	________	________
________	________	________
6. Other:		
________	________	________
________	________	________

Total to be Paid on Authorization of Borrower . . . . $ ________

If this loan is secured by a first deed of trust on dwellings in a principal amount of less than $30,000 or secured by a junior lien on dwellings in a principal amount of less than $20,000, the undersigned licensee certifies that the loan will be made in compliance with Article 7 of Chapter 3 of the Real Estate Law.

*This loan ☐ **may** ☐ **will** ☐ **will not** (check one) be made wholly or in part from broker-controlled funds as defined in Section 10241(j) of the Business and Professions Code.

REVISION DATE 10/2000
MS-11 (PAGE 2 OF 3)

Borrower acknowledges receipt of copy of this page.
Borrower's Initials (________)(________)

Reviewed by
Broker or Designee ________ Date ________

EQUAL HOUSING OPPORTUNITY

Property Address: _______________ Date: ________

***NOTICE TO BORROWER:** This disclosure statement may be used if the Broker is acting as an agent in arranging the loan by a third person or if the loan will be made with funds owned or controlled by the broker. If the Broker indicates in the above statement that the loan "may" be made out of Broker-controlled funds, the Broker must notify the borrower prior to the close of escrow if the funds to be received by the Borrower are in fact broker-controlled funds.

Name of Broker		Broker Representative
License Number		License Number
Signature of Broker	OR	Signature

The Department of Real Estate License Information phone number is _______________ .

NOTICE TO BORROWER:

DO NOT SIGN THIS STATEMENT UNTIL YOU HAVE READ AND UNDERSTAND ALL OF THE INFORMATION IN IT. ALL PARTS OF THE FORM MUST BE COMPLETED BEFORE YOU SIGN.

Borrower hereby acknowledges the receipt of a copy of this statement.

DATED _______________ _______________ (Borrower)

_______________ (Borrower)

Broker Review: Signature of Real Estate Broker after review of this statement.

DATED _______________ _______________ Real Estate Broker or Assistant Pursuant to Section 2725

Published and Distributed by:
REAL ESTATE BUSINESS SERVICES, INC.
a subsidiary of the CALIFORNIA ASSOCIATION OF REALTORS®
525 South Virgil Avenue, Los Angeles, California 90020

Reviewed by
Broker or Designee ________ Date________

EQUAL HOUSING OPPORTUNITY

REVISION DATE 10/2000
MS-11 (PAGE 3 OF 3)

MORTGAGE LOAN DISCLOSURE STATEMENT (MS-11 PAGE 3 OF 3)

T7791671.ZFX

PURCHASE MONEY CREDIT EXTENDED BY SELLERS

For purchase money credit applies to seller carryback credit situations involving one– to four–family dwellings.

Arranger of Credit – In California law, an **"**arranger of credit**"** is:

- A person, other than a party to the transaction, who is involved in developing or negotiating credit terms, or any transaction or transfer of real property which is facilitated by that extension of credit, excluding attorneys, or

- A party to the transaction who is a real estate licensee or an attorney.

Application

Applies to seller carryback situations involving 1– to 4–family dwellings.

Exempt Transactions – Disclosures under this law are not required:

- When the purchaser is entitled to receive a federal Truth in Lending disclosure statement, a RESPA disclosure statement, or a Mortgage Loan Broker's Statement, under Article 7.

- When the vendor is entitled to receive a disclosure statement under Article 5, California Real Estate Law, or certain disclosures required by Corporations Code Section 25110.

Disclosure Requirements

When credit is extended by the seller and there is an **"**arranger of credit,**"** disclosure responsibilities are as follows:

- A written disclosure shall be given to the purchaser by the arranger of credit and vendor, and

- To the vendor by the arranger of credit and buyer.

- If two or more arrangers of credit are involved, the one who has obtained the offer to purchase makes the disclosure.

DISCLOSURE DOCUMENT

The CAR Seller Financing Disclosure Statement form, (Form 11–2), is a common standard form for this disclosure statement.

Contents – The required disclosures include both specific terms of the transaction at hand, and general disclosures about the financing process:

- Identification of the note (or other documents) and of the property used as security
- Description of terms or a copy of them
- Description and conditions of each recorded senior lien
- Any cash purchaser is to receive (source and purpose)
- A warning of difficulties which may arise in refinancing, if full amortization does not occur
- A disclosure whether negative amortization can occur
- Possible acceleration clauses
- Possible balloon payments
- Information about credit of borrower, his income, and a warning about Section 580b as to "deficiency judgments"
- Loss–payee clauses in insurance
- Title insurance coverages
- Tax service
- The importance of recording

Timing – Disclosure must be given before execution of the note or security documents. Buyer and vendor must give a written receipt for the disclosure; arranger must keep a copy for 3 years.

Form 11-1: Seller Financing and Disclosure

CALIFORNIA ASSOCIATION OF REALTORS®

SELLER FINANCING ADDENDUM AND DISCLOSURE

(California Civil Code §§2956-2967)

This is an addendum to the ☐ Residential Purchase Agreement, ☐ Counter Offer, or ☐ Other ______________________________ ______________________________, ("Agreement"), dated ______________.

On property known as ______________________________ ("Property"),

In which ______________________________ is referred to as Buyer,

and ______________________________ is referred to as Seller.

Seller agrees to extend credit to Buyer as follows:

1. **PRINCIPAL; INTEREST; PAYMENT; MATURITY TERMS:** ☒ Principal amount $ ____________, interest at ________ % per annum, payable at approximately $ ____________ per ☐ month, ☐ year, or ☐ other ____________, remaining principal balance due in ______ years.
2. **LOAN APPLICATION; CREDIT REPORT:** Within 5 (or ☐ ________) **Days** After Acceptance: **(a)** Buyer shall provide Seller a completed loan application on a form acceptable to Seller (such as a FNMA/FHLMC Uniform Residential Loan Application for residential one to four unit properties); and **(b)** Buyer authorizes Seller and/or Agent to obtain, at Buyer's expense, a copy of Buyer's credit report. Buyer shall provide any supporting documentation reasonably requested by Seller. Seller may cancel this Agreement in writing if Buyer fails to provide such documents within that time, or if Seller disapproves any above item within 5 (or ☐ ______) **Days** After receipt of each item.
3. **CREDIT DOCUMENTS:** This extension of credit by Seller will be evidenced by: ☐ Note and deed of trust; ☐ All-inclusive note and deed of trust; ☐ Installment land sale contract; ☐ Lease/option (when parties intend transfer of equitable title); OR ☐ Other (specify) ______________________________.

THE FOLLOWING TERMS APPLY ONLY IF CHECKED. IF NOT CHECKED, THE TERM IS NOT PART OF THE SELLER FINANCING.

4. ☐ **LATE CHARGE:** If any payment is not made within ______ **Days** After it is due, a late charge of either ☐ $ ____________, or ________ % of the installment due, may be charged to Buyer. **NOTE:** on single family residences that Buyer intends to occupy, Civil Code §2954.4(a) limits the late charge to no more than 6% of the total monthly payment due and requires a grace period of no less than 10 days.
5. ☐ **BALLOON PAYMENT:** The loan will provide for a balloon payment, in the amount of $ ____________, plus any accrued interest, which is due on ____________ (date).
6. ☐ **PREPAYMENT:** If all or part of this loan is paid early, Seller may charge a prepayment penalty as follows (if applicable): ______________________________. Caution: Civil Code §2954.9 contains limitations on prepayment penalties for residential one-to-four unit properties.
7. ☐ **DUE ON SALE:** If any interest in the Property is sold or otherwise transferred, Seller has the option to require immediate payment of the entire unpaid principal balance, plus any accrued interest.
8.* ☐ **REQUEST FOR COPY OF NOTICE OF DEFAULT:** A Request for a copy of Notice of Default under Civil Code §2924(b) will be recorded. **If Not,** Seller is advised to consider recording a Request for Notice of Default.
9.* ☐ **REQUEST FOR NOTICE OF DELINQUENCY:** A Request for Notice of Delinquency, as defined in Civil Code §2924(e), to be signed and paid for by Buyer, will be made to senior leinholders. **If not,** Seller is advised to consider making a Request for Notice of Delinquency. Seller is advised to check with senior leinholders to verify whether they will honor this request.
10.* ☐ **TAX SERVICE:**
    A. If property taxes on the Property become delinquent, tax service will be arranged to report to Seller. **If not,** Seller is advised to consider retaining a tax service, or to otherwise determine that property taxes are paid.
    B. ☐ Buyer, ☐ Seller, shall be responsible for the initial and continued retention of, and payment for, such tax service.
11. ☐ **TITLE INSURANCE:** Title insurance coverage will be provided to **both** Seller and Buyer, insuring their respective interests in the Property. **If Not,** Buyer and Seller are advised to consider securing such title insurance coverage.
12. ☐ **HAZARD INSURANCE:**
    A. The parties' escrow holder or insurance carrier will be directed to include a loss payee endorsement, adding Seller to the Property insurance policy. **If Not,** Seller is advised to secure such an endorsement, or acquire a separate insurance policy.
    B. Property insurance **does not** include earthquake or flood insurance coverage, unless checked:
    ☐ Earthquake insurance will be obtained; ☐ Flood insurance will be obtained.
13. ☐ **PROCEEDS TO BUYER:** Buyer will receive cash proceeds at the close of the sale transaction. The amount received will be approximately $ ____________, from ______________________________ (indicate source of proceeds). Buyer represents that the purpose of such disbursement is as follows: ______________________________.

***See footnote on page 2.**

Buyer and Seller acknowledge receipt of copy of this page.

Buyer's Initials (________) (________)

Seller's Initials (________) (________)

EQUAL HOUSING OPPORTUNITY

Reviewed by

Broker or Designee ____________ Date ____________

REVISION DATE 10/2000
SFA-11 (PAGE 1 OF 3)

SELLER FINANCING ADDENDUM AND DISCLOSURE (SFA-11 PAGE 1 OF 3)

jerry fung
JF 2373 S Hacienda Blvd , Hacienda Heights CA 91745 Phone: (626)336.6191 Fax: (626)336.8565 T7860169.ZFX

REAL ESTATE FINANCE

Property Address: ______________________________ Date: ______________

14. ☐ **NEGATIVE AMORTIZATION; DEFERRED INTEREST:** Negative amortization results when Buyer's periodic payments are less than the amount of interest earned on the obligation. Deferred interest also results when the obligation does not require periodic payments for a period of time. In either case, interest is not payable as it accrues. This accrued interest will have to be paid by Buyer at a later time, and may result in Buyer owing more on the obligation than at its origination. The credit being extended to Buyer by Seller will provide for negative amortization or deferred interest as indicated below. (Check A, B, or C. CHECK ONE ONLY.)

☐ **A.** All negative amortization or deferred interest shall be added to the principal ______________ (e.g., annually, monthly, etc.), and thereafter shall bear interest at the rate specified in the credit documents (compound interest);

OR ☐ **B.** All deferred interest shall be due and payable, along with principal, at maturity;

OR ☐ **C.** Other ______________________________.

15. ☐ **ALL-INCLUSIVE DEED OF TRUST; INSTALLMENT LAND SALE CONTRACT:** This transaction involves the use of an all-inclusive (or wraparound) deed of trust or an installment land sale contract. That deed of trust or contract shall provide as follows:

A. In the event of an acceleration of any senior encumbrance, the responsibility for payment, or for legal defense is: ______________ ; OR ☐ **Is not** specified in the credit or security documents.

B. In the event of the prepayment of a senior encumbrance, the responsibilities and rights of Buyer and Seller regarding refinancing, prepayment penalties, and any prepayment discounts are: ______________ ; OR ☐ **Are not** specified in the documents evidencing credit.

C. Buyer will make periodic payments to ______________ (Seller, collection agent, or any neutral third party), who will be responsible for disbursing payments to the payee(s) on the senior encumbrance(s) and to Seller. **NOTE:** The Parties are advised to designate a neutral third party for these purposes.

16. ☐ **TAX IDENTIFICATION NUMBERS:** Buyer and Seller shall each provide to the other their Social Security Numbers or Taxpayer Identification Numbers.

17. ☐ **OTHER CREDIT TERMS:** ______________________________.

18. ☐ **RECORDING:** The documents evidencing credit (paragraph 3) will be recorded with the county recorder where the Property is located. **If Not,** Buyer and Seller are advised that their respective interests in the Property may be jeopardized by intervening liens, judgments, encumbrances, or subsequent transfers.

19. ☐ **JUNIOR FINANCING:** There will be additional financing, secured by the Property, junior to this Seller financing. Explain: ______________________________.

* (For Paragraphs 8-10) In order to receive timely and continued notification, Seller is advised to record appropriate notices and/or to notify appropriate parties of any change in Seller's address.

20. SENIOR LOANS; ENCUMBRANCES: The following information is provided on loans and/or encumbrances that will be **senior** to Seller financing. **NOTE:** The following are estimates, unless otherwise marked with an asterisk (*). If checked: ☐ A separate sheet with information on additional senior loans/encumbrances is attached.

	1st	2nd
A. Original Balance	$ ______	$ ______
B. Current Balance	$ ______	$ ______
C. Periodic Payment (e.g. $100/month):	$ ______ / ______	$ ______ / ______
Including Impounds of:	$ ______ / ______	$ ______ / ______
D. Interest Rate (per annum)	______ %	______ %
E. Fixed or Variable Rate:	______	______
If Variable Rate: Lifetime Cap (Ceiling)	______	______
Indicator (Underlying Index)	______	______
Margins	______	______
F. Maturity Date	______	______
G. Amount of Balloon Payment	$ ______	$ ______
H. Date Balloon Payment Due	______	______
I. Potential for Negative Amortization? (Yes, No, or Unknown)	______	______
J. Due on Sale? (Yes, No, or Unknown)	______	______
K. Pre-payment penalty? (Yes, No, or Unknown)	______	______
L. Are payments current? (Yes, No, or Unknown)	______	______

Buyer and Seller acknowledge receipt of copy of this page.

Buyer's Initials (________) (________)

Seller's Initials (________) (________)

EQUAL HOUSING OPPORTUNITY

Reviewed by

Broker or Designee __________ Date __________

Property Address: ____ Date: ______________

21. BUYER'S CREDITWORTHINESS: (CHECK EITHER A OR B. Do not check both.) In addition to the loan application, credit report and other information requested under paragraph 2:

A. ☐ No other disclosure concerning Buyer's creditworthiness has been made to Seller;

OR B. ☐ The following representations concerning Buyer's creditworthiness are made by Buyer(s) to Seller:

Borrower ______________	Co-Borrower ______________
1. Occupation ______________	1. Occupation ______________
2. Employer ______________	2. Employer ______________
3. Length of Employment ______________	3. Length of Employment ______________
4. Monthly Gross Income ______________	4. Monthly Gross Income ______________
5. Other ______________	5. Other ______________

22. ADDED, DELETED OR SUBSTITUTED BUYERS: The addition, deletion or substitution of any person or entity under this Agreement or to title prior to close of escrow shall require Seller's written consent. Seller may grant or withhold consent in Seller's sole discretion. Any additional or substituted person or entity shall, if requested by Seller, submit to Seller the same documentation as required for the original named Buyer. Seller and/or Brokers may obtain a credit report, at Buyer's expense, on any such person or entity.

23. CAUTION:

A. If the Seller financing requires a balloon payment, Seller shall give Buyer written notice, according to the terms of Civil Code §2966, at least 90 and not more than 150 days before the balloon payment is due if the transaction is for the purchase of a dwelling for not more than four families.

B. If **any** obligation secured by the Property calls for a balloon payment, Seller and Buyer are aware that refinancing of the balloon payment at maturity may be difficult or impossible, depending on conditions in the conventional mortgage marketplace at that time. There are no assurances that new financing or a loan extension will be available when the balloon prepayment, or any prepayment, is due.

C. If **any** of the existing or proposed loans would require refinancing as a result of a lack of full amortization, such refinancing might be difficult or impossible in the conventional mortgage marketplace.

D. In the event of default by Buyer: (1) Seller may have to reinstate and/or make monthly payments on any and all senior encumbrances (including real property taxes) in order to protect Seller's secured interest; (2) Seller's rights are generally limited to foreclosure on the Property, pursuant to Code of Civil Procedure §580(b); and (3) the Property may not have sufficient equity to protect Seller's interests because Property may have decreased in value.

If this three-page Addendum and Disclosure is used in a transaction for the purchase of a dwelling for not more than four families, it shall be prepared by an Arranger of Credit as defined in Civil Code §2957(a). (The Arranger of Credit is usually the agent who obtained the offer.)

____
Arranger of Credit (Print Firm Name) By Date

____
Address City State Zip Phone Fax

BUYER AND SELLER ACKNOWLEDGE AND AGREE THAT BROKERS: (A) WILL NOT PROVIDE LEGAL OR TAX ADVICE; (B) WILL NOT PROVIDE OTHER ADVICE OR INFORMATION THAT EXCEEDS THE KNOWLEDGE, EDUCATION AND EXPERIENCE REQUIRED TO OBTAIN A REAL ESTATE LICENSE; OR (C) HAVE NOT AND WILL NOT VERIFY ANY INFORMATION PROVIDED BY EITHER BUYER OR SELLER. BUYER AND SELLER AGREE THAT THEY WILL SEEK LEGAL, TAX, AND OTHER DESIRED ASSISTANCE FROM APPROPRIATE PROFESSIONALS. BUYER AND SELLER ACKNOWLEDGE THAT THE INFORMATION EACH HAS PROVIDED TO THE ARRANGER OF CREDIT FOR INCLUSION IN THIS DISCLOSURE FORM IS ACCURATE. BUYER AND SELLER FURTHER ACKNOWLEDGE THAT EACH HAS RECEIVED A COMPLETED COPY OF THIS DISCLOSURE FORM.

Buyer ______________________________ (signature) Date __________
Address ______________ City ______________ State ______ Zip ______
Phone ______________ Fax ______________ E-mail ______________

Buyer ______________________________ (signature) Date __________
Address ______________ City ______________ State ______ Zip ______
Phone ______________ Fax ______________ E-mail ______________

Seller ______________________________ (signature) Date __________
Address ______________ City ______________ State ______ Zip ______
Phone ______________ Fax ______________ E-mail ______________

Seller ______________________________ (signature) Date __________
Address ______________ City ______________ State ______ Zip ______
Phone ______________ Fax ______________ E-mail ______________

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REVISION DATE 10/2000
SFA-11 (PAGE 3 OF 3)

Reviewed by
Broker or Designee __________ Date __________

EQUAL HOUSING OPPORTUNITY

SELLER FINANCING ADDENDUM AND DISCLOSURE (SFA-11 PAGE 3 OF 3)

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BALLOON PAYMENTS

If a balloon payment is involved, the holder of the note must mail to the trustor or successor in interest, not less than 90 days nor more than 150 days before the balloon is due,

- The name and address of the person to whom payment is due,
- The date and amount due, and
- Statement of trustor's right to refinance, if any.

Failure to give notice postpones due date until 90 days after mailing or delivery of notice.

Civil Code § 29241 – A similar requirement of notice at least 90 days in advance applies to all loans with balloon payments:

- On owner–occupied one– to four–family properties
- Made after January 1, 1984
- For a term in excess of one year

Disclosure – The note must include a disclosure of the right to receive notice of an impending balloon payment.

REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)

RESPA was passed in 1974 to standardize the settlement or closing of real estate transactions. According to the act, the purpose was to affect certain changes in the settlement procedures for residential real estate transactions that will result:

- In more effective advance disclosure to the homebuyer and seller of settlement costs.

- In the elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services.
- In a reduction in the amounts homebuyers are required to place in escrow accounts.
- In significant reform and modernization of local record keeping of land title information.

In this discussion only some portions of RESPA dealing with the closing of residential transactions will be discussed.

APPLICATION

RESPA applies to a federally–related loan secured by a first security interest, on a one–to four–unit residential property.

- **Federally–Related** – This term is broad enough to include loans made by any lender insured by FDIC or FSLIC, or approved to make FHA–insured or DVA–guaranteed loans.

☞ ***From this definition, it is obvious that the majority of conventional principal residence loans are covered by RESPA.***

DISCLOSURE REQUIREMENTS

For any loan transaction covered by the Act, the lender must comply with the following requirements.

- **HUD Brochure** – The lender must send a brochure to each loan applicant on receipt of the application. The entire text of the brochure is prescribed by the Secretary of Housing and Urban Development in 12 US Code § 2604.
- **Estimate of Closing Costs** – The lender must also provide a good faith estimate of all closing costs, including: All fees charged by the lender, such as:
    - Loan origination fee

- Appraisal fee
- Credit report expenses

- Closing costs charged by others, such as:
  - Escrow fees
  - Title insurance costs
  - Recording fees

SETTLEMENT STATEMENT

The "person conducting the settlement" (usually the escrow holder) must provide to both seller and buyer a completed Uniform Settlement Statement (HUD–1 Statement).

- **Timing** – The Uniform Settlement Statement must be delivered or mailed to the borrower and the seller at or before settlement. Upon request of the borrower, the person conducting the settlement must permit the borrower to inspect the Uniform Settlement Statement one day prior to settlement.

- **Exceptions** – The statement may be provided by mail as soon as possible after the settlement if:
  - The escrow holder does not require a meeting of the parties,
  - The borrower or borrower's agent does not attend the settlement in person, or
  - The borrower waives in writing the right to delivery of the completed statement.

The Real Estate Settlement Procedures Act (RESPA) is a federal law designed to give buyers and sellers advance notice of closing costs, to allow them to "comparison shop" and obtain the lowest available costs.

RESPA has nine basic requirements:

The first two provisions require the lender to provide the applicant with the good faith estimate of costs and the HUD booklet on settlement costs.

The remainder of the provisions cover the actual closing of the transaction:

3. **Uniform Settlement Statement** – RESPA requires the use of the Uniform Settlement Statement, otherwise known as either HUD Form 1 or the closing statement. This statement will be reviewed later in this section.

4. **Selection of the title company** – RESPA makes it illegal for the seller to condition the sale of the property that will be purchased with the assistance of a federally related mortgage ban, upon the buyer's selection of the title company. This means that the seller cannot force the buyer to use a specific title company.

5. **Kickbacks** – RESPA prohibits anyone involved in the transaction from receiving or giving a fee, kickback, or anything of value for the promise of future business. It also makes the acceptance or offer of a fee illegal when no service has been rendered. It should be noted that this requirement does not prohibit a per–son who actually provides a service in the transaction from collecting a fee or payment for services. It does prohibit, for example, a title or mortgage company from making an agreement with a real estate agent or firm, so that for every closing or applicant the agent or firm sends, the agent or firm will receive something of value.

6. **Escrows** – RESPA prohibits the lender from collecting excessive amounts to be placed in escrow accounts. The act allows the lender to collect sufficient amounts to make necessary payments plus 2 months of escrow deposits. Thus, at the time of closing, the mortgage lender usually requires the collection of 2 months of escrow payments for taxes, insurance (homeowners), PMI premiums, and any other fee or assessment that will affect the title to the property. The lender will collect the first year's premium for both homeowners' insurance and PM if required, for a total of 14 months for each.

7. **Preparation of the Uniform Settlement Statement and Truth–in–Lending statement** – The lender is prohibited from charging a fee for the preparation of these two statements. It should be noted that only the lender is prohibited from charging a fee for the preparation of the statements.

8. **Loans to fiduciaries** – Institutions insured by FDIC must require that the borrower disclose the identity of the person or company receiving the beneficial interest in a loan made to a fiduciary. Fiduciary is the holding by a person or organization of something in trust. Thus, if you are purchasing a piece of property from a person or organization that is holding the property in trust, the institution will require the person or organization holding the property, to identify the person or persons who will ultimately benefit from the proceeds of the mortgage.

9. **Preview of settlement statement** – The final provision of RESPA allows the borrower or his or her agent to view the Uniform Settlement Statement one business day prior to the closing and see the amount the borrower may be required to pay at the time of closing. This reviewing of the Uniform Settlement Statement is a good idea not only for the borrower, but also for the real estate agent who represents the borrower. This will allow the borrower to have either sufficient cash or a cashier's check to pay the required amount. If the agent reviews the Uniform Settlement Statement prior to closing, he or she can see if the buyer is paying the proper items and amounts outlined in the earnest money contract. Thus, there will be no surprises at the time of closing.

PROHIBITIONS

In an effort to hold down closing costs, Congress included some prohibitions and limitations in the law.

- No giving or accepting kickbacks or unearned fees (referral fees) to unlicensed persons for settlement related activities.
- Limitations are placed on the initial amounts which a lender may collect for establishing new insurance and tax reserves

EXCLUSIONS

RESPA does not apply to construction and home improvement loans, vacant lots, parcels of 25 acres or more, assumptions, property purchased for resale, land sales contracts, or any transaction in which title is not transferred.

HOUSING FINANCIAL DISCRIMINATION ACT

The **Housing Financial Discrimination Act of 1977** (Holden Act), was enacted in California in 1977 to deter a discriminatory practice known as ***"redlining,"*** the blanket refusal by some lenders to make loans in neighborhoods of fading property values.

The Holden Act applies to **owner–occupied residential properties** of one to four units. The act also includes non–owner–occupied loans on up to four units if 50% or more of the loan proceeds are to be used to improve the property.

- Application
  - **Borrower** – The Holden Act prohibits consideration of an applicant's race, color, religion, sex, marital status, national origin, or ancestry in providing financial assistance.
  - **Neighborhood** – Financial assistance cannot be denied because of the ethnic composition or expected trends in the neighborhood.
- **Allowable Considerations** – While the Act prohibits discrimination in lending and appraisal practices, it does not preclude a lender's considering the fair market value of property which will be used to secure the loan, nor require the lender to lend if it is evident that occupancy of the property will endanger the health and safety of the resident.

DISCLOSURE

To insure that prospective borrowers are aware of their rights under this law, lenders must notify all loan applicants at the time of the completed loan application of the existence of the Holden Act.

- **Form and Content** – The notice must include the address where complaints may be filed and information may be obtained. The notice must be in at least 10 point type and must also be posted in a conspicuous location in the lender's place of business.
- **Complaints** – Any applicant seeking a real estate loan for a personal residence (not more than four dwelling units) who suspects discrimination under this law, may file a complaint with the Secretary of the Business, Transportation, and Housing Agency.

- **Compliance** – If the secretary or designee finds that a lender has engaged in unlawful practices, the lender may be required to make the loan, or if that is no longer a viable solution, the lender may be made to pay damages to the complainant.

PURPOSE

The act states that financial institutions cannot deny or discriminate in fixing the amount, interest rate, or length of the loan based upon

- Race, color, religion, sex, marital status, sexual orientation, national origin, handicap, ancestry, or other characteristics of the borrower

- Racial, ethnic, religious, national origin, or income–level composition of a neighborhood or whether that composition is expected to change.

  The act also prohibits *discrimination by effect***.** That means that the institution cannot engage in a lending practice that has a discriminatory effect against a protected group, unless that practice is required to achieve a legitimate business purpose. If it is clear that a practice has a discriminatory effect, then the burden is on the institution to show that the practice is required. This is called the ***"****Effects Test.****"***

  Some examples of discrimination by effect are rejecting a borrower because of an isolated credit difficulty or credit difficulties in the distant past; not including income from overtime or part–time work, or being overly restrictive on payment–to–income ratios when qualifying borrowers. These practices would discriminate against minority and lower–income groups.

  It was previously indicated that the institution can adjust the terms of the loan, if necessary, to avoid unsafe and unsound business practices. The act has spelled out further regulations in regard to this.

- Neighborhood considerations (such as characteristics, or trends in the neighborhood, Location of the property in the neighborhood, etc) unless the institution can prove that such considerations are necessary to avoid unsafe and unsound business practices

Form 11-1: Fair Lending Notice

The Housing Financial Discrimination Act of 1977
Fair Lending Notice

It is illegal to discriminate in the provision of or in the availability of financial assistance because of the consideration of:

1. Trends, characteristics or conditions in the neighborhood or geographic area surrounding a housing accommodation, unless the financial institution can demonstrate in the particular case that such consideration is required to avoid an unsafe and unsound business practice: or
2. Race, color, religion, sex, marital status, national origin or ancestry.

It is illegal to consider the racial, ethnic, religious or national origin composition of a neighborhood or geographic area surrounding a housing accommodation or whether or not such composition is undergoing change, or is expected to undergo change, in appraising a housing accommodation or in determining whether or not, or under what terms and conditions, to provide financial assistance.

These provisions govern financial assistance for the purpose of the purchase, construction, rehabilitation or refinancing of one to four unit family residences occupied by the owner and for the purpose of the home improvement of any one to four unit family residence.

If you have any questions about your rights, or if you wish to file a complaint, contact the management of this financial institution or the Department of Real Estate at one of the following locations:

1515 Clay Street, Suite 702, Oakland, CA 94612
320 West 4th Street, Suite 350, Los Angeles, CA 90013

ACKNOWLEDGEMENT OF RECEIPT

I (we) received a copy of this notice.

Signature of Applicant Date

FEDERAL EQUAL CREDIT OPPORTUNITY ACT

The Federal Equal Credit Opportunity Act makes it unlawful for a creditor (lender) to discriminate against any applicant on the basis of race, color, religion, national origin or ancestry, sex, marital status, or age (provided the applicant has a capacity to contract). The required disclosure is the Notice of Adverse Action.

ADVERSE ACTION

The denial, revocation, or change in the terms of an existing credit arrangement is an adverse action. It does not include a refusal to extend credit under an existing credit arrangement where the applicant is delinquent or otherwise in default. Nor does it include additional credit which would cause an extension of credit to exceed an already established limit.

APPLICATION

According to the law, any creditor who decides to deny an application for credit must provide the applicant with a statement of reasons, or a written notification of the applicant's right to obtain a statement of reasons.

- **Timing** – The statement of reasons may be given by the lender as a matter of course with the notice of adverse action. In most cases, this must be provided within 30 days after receiving the completed loan application. For some types of credit transactions, this time limit is longer.

Some of the basic provisions of the act that affect real estate lenders are these:

- If applicants request, lenders must consider information provided by the borrowers indicating that a bad history of a joint account does not reflect on their credit.
- Lenders cannot ask about birth control practices or childbearing intentions or capabilities.
- ***Lenders cannot ask if the borrower is divorced or widowed.*** They may ask if the borrower is married, unmarried, or separated. For purposes of the law, unmarried means single, divorced, or widowed.

- Lenders cannot ask about receiving alimony or child support unless the borrower is first notified that it need not be revealed. However, lenders may ask about obligations to pay alimony or child support.

- Lenders must notify applicants in writing within 30 days as to what action has been taken on their applications. In case of disapproval, the reason must be given.

CHAPTER QUIZ

1. Federal Reserve Regulation Z is enforced by:

   A HUD
   B The State Fair Employment Practices Commission
   C The Federal Trade Commission
   D None of the above

2. In general, the Truth in Lending Act applies to:

   A Creditors
   B Advertisers of credit
   C. Discrimination involving credit
   D. Both "A" and "B"

3. The "Annual Percentage Rate" written in bold letters is required by the:

   A Truth in Lending Act
   B Federal Reserve Regulation Z
   C Federal Consumer Credit Protection Act
   D All of the above

4. If the loan is secured by the borrower's residence, a borrower has the right to rescind before midnight of the third business day following consummation of a contract, with the ***exception*** of a:

   A Loan for construction of a new dwelling
   B First trust deed used to finance the acquisition of a dwelling

C Neither “A” nor “B”
D Both “A” and “B

5. Federal Reserve Regulation Z:

A. Never applies to real estate brokers
B Applies to all advertising of real estate brokers
C Applies to advertising of real estate brokers only if some of the available credit terms are given
D. None of the above

6. Disclosure requirements for purchase money credit extensions by sellers, or seller carryback situations, are prescribed by:

A Regulation Z
B California Civil Code
C RESPA
D. All of the above

7. RESPA prohibits:

A. A seller insisting, as a condition of sale, that the buyer use a particular title company
B. The forced sale of a residence
C Claims against unsecured judgments
D. A licensee from advising on a homestead issue

8. The federal law designed to protect and inform homebuyers against unnecessarily high closing costs is known as the:

A. Equal Credit Opportunity Act
B. Real Estate Settlement Procedures Act
C. Uniform Settlement Statement
D. Consumer Credit Protection Act

9. The federal law designed to prevent discrimination by lenders based on sex is known as the:

A. Equal Credit Opportunity Act
B. Real Estate Settlement Procedures Act
C. Uniform Settlement Statement
D. Consumer Credit Protection Act

10. The Holden Act primarily addresses:

    A. Sex and age discrimination
    B. Redlining
    C. Health and safety
    D. Variable rate disclosures

Answer Key: 1–C, 2–D, 3–D, 4–C, 5–B, 6–A, 7–A, 8–B, 9–A, 10–B

CHAPTER 12: QUALIFYING THE PROPERTY

PREVIEW

This chapter describes the procedures lenders use in qualifying or appraising a property for loan purposes: The neighborhood is analyzed, the property is inspected, and a value is determined so that a loan may be arranged. This chapter also reviews use of an appraisal form in depth and lists special considerations by lenders on planned unit developments and condominiums.

LOAN UNDERWRITING DECISIONS

There are two basic elements involved in determining the appropriate lending decision on residential real estate:

1. Determination of the value of the underlying collateral by means of an appraisal. This serves to determine the upper limit of loan advance.

2. Determination of the borrower's capacity to service the debt in a satisfactory manner – the subject matter of this chapter. Insofar as the second aspect of the process is concerned, this upper limit of loan advance may remain the same or be lowered based upon the borrower's repayment ability.

QUALIFYING THE BORROWER

The prospective borrower must be qualified in terms of ability to repay the loan and willingness to repay – credit record. Qualifying the borrower will be discussed in next chapter.

Qualifying the Property

Real estate appraisers evaluate a neighborhood with great care because location has a great influence on the value of a property. Appraisers also pay particular attention to the condition and quality of the property. It is important to note, however, that redlining is illegal.

- **Residential Property** – It is the personal income of the borrower that is expected to repay a loan on a personal residence. For a qualified borrower, the qualification of the property becomes significant in case the borrower's ability or willingness to pay should change. The property value must be adequate to provide a security for the loan. In a foreclosure, the sale of the property would be expected to bring in adequate funds to repay the debt.

- **Income Property** – For loans on income– producing properties, it is the income of the property that is expected to repay the loan. The property must be evaluated not only as a security for the loan in the event of default, although that is an important consideration, but also in terms of adequacy of the income to repay the debt, in quantity and stability.

ESTIMATING VALUE USING APPRAISAL METHODS

Purposes of Appraisal in Real Estate

Appraisal is defined as a supportable or defensible estimate of a property's value as of a particular time. Buyers, sellers, and lenders all need such information in a real estate transaction.

- **Lending** – Government regulatory agencies which supervise the lending activities of banks, savings and loan associations, insurance companies, credit unions, pension funds, and other lending entities, usually require that a professional appraisal be prepared.

- **Basis for Decisions** – Lending institutions will make underwriting decisions based on the data, analysis, and conclusions set forth in the appraisal. These underwriting decisions include:
  - The loan–to–value ratio, or the amount to be loaned as a percentage of the property value.
  - The appropriate number of years over which to amortize the principal of the loan, based on value trends in the area and the age and condition of the property.
  - The appropriate interest rate, considering the lender's cost of money and the relative risk of suffering a loss through foreclosure of the loan.

ETHICS

The Real Estate Commissioner's Suggestions for Professional Conduct, a companion to the Code of Professional Conduct (Regulation 2875, Title 10, California Code of Regulation), encourages real estate licensees to **"**advertise or claim to be an expert in an area of specialization in real estate brokerage activity, e.g., appraisal, property management, industrial sitting, mortgage loan, etc., only if the licensee has had special training, preparation or experience.**"**

USING A STANDARD APPRAISAL FORMS

For single–family residences, a form report is usually satisfactory. The government makes stringent requirements as to form and support in appraisals for loans where government insurance or guarantees are involved.

The form shown in Form 12–1 is the standard used by Fannie Mae and Freddie Mac (and since its adoption by the agencies, most lenders have come to use it as well), with some exceptions that we need not go into here (e.g., lenders participating in FNMA's *Desktop Underwriter program*).

The appraisal form is divided into three basic sections: first, ***neighborhood data,*** or characteristics; second, ***information on the property***; and third, ***valuation***, as illustrated in Form 12–1.

ESTIMATE VALUE BY EACH OF THE APPRAISAL METHODS

There are three approaches used for appraisal, they are the sales comparison approach, the cost approach and the income approach. Occasionally only one approach will be appropriate, because only limited data will be available for some properties.

SALES COMPARISON APPROACH / MARKET DATA APPROACH

In the sales comparison approach, the sales prices of recently sold comparable properties are adjusted to derive an estimate of value for the property under appraisal.

The ***sales comparison*** or ***market data approach*** to appraising makes the most direct use of the **principle of substitution**. The appraiser finds three to five (or more) properties that have sold recently and are similar to the subject property. The appraiser notes any dissimilar features and makes an adjustment for each by using the following formula:

☞ ***Value of Subject Property = Sales Price of Comparable Property +/– Adjustments***

The appraiser adds to the sales price of a comparable property the value of a feature present in the subject property but not in the comparable. The appraiser subtracts from the sales price of the comparable property the value of a feature present in the comparable but not in the subject property. Major types of adjustments include those made for physical (on–site) features, locational (off–site) influences, conditions of sale (buyer–seller motivation and financing terms), and time from date of sale. After going through this process for each of the comparable properties, the appraiser assigns a value to the subject property that is the adjusted sales price of the comparable(s) most like the subject.

The two keys to effective use of the sales comparison approach are:

- Identifying similar properties that are truly “comparable” to the subject property, and

- Making the proper adjustments to the sales prices of the comparable properties to account for any differences between the subject property and the comparables.

It is relatively rare, however, to find two properties that are so comparable that there is no difference in their values. For this reason, the adjustment process is central to the sales comparison approach. In the adjustment process, the sales price of the comparable property is adjusted (up or down) to reflect aspects of the comparable property that are viewed as less valuable or more valuable in comparison to the subject property

☞ ***Example:***

House A, which sold for $55,000, is comparable to house B, the subject property, but has a garage valued at $5,000. House B has no garage. In this case, using the formula for the sales comparison approach, the market value of the subject property would be reached as shown below.

$55,000 – $5,000 = $50,000
House B is valued at $50,000.

☞ ***Example:***

House X, the subject property, is 15 years old. A comparable property, house Y, is 15 years old and sold for $70,000 one year prior to this appraisal. Because of changes in market conditions since the sale of house Y, the appraiser has determined that 10 percent added to the sales price is an accurate reflection of the increase in property values over the year. In this case, using the formula for the sales comparison approach:

Value of Subject Property = $70,000 + (10% x $70,000) = $77,000

House X is valued at $77,000.

COST APPROACH

In the cost approach, the cost of property improvements, less depreciation on improvements, is added to site value.

In the **cost approach**, the appraiser estimates the value of any improvements to the land (such as structures) in terms of their reproduction or replacement cost as though new. The appraiser then subtracts any loss in value owing to the depreciation of the improvements. Finally, the appraiser adds an estimate of the value of the site itself, usually found by the sales comparison approach. The formula for the cost approach is:

☞ ***Property Value = Reproduction or Replacement Cost of Improvements – Depreciation Improvement(s) + Site Value***

Depreciation may occur through either *deterioration* (effects of wear and tear or the elements) or *obsolescence*. **Obsolescence** can be functional, such as outmoded room layout or design, or external, caused by changes in factors outside the property such as zoning, the property's highest and best use, or supply and demand.

☞ ***Example:***

A house being appraised is similar in size, design, and quality of construction to a new house that has a construction cost of $125,000. The house being appraised has depreciated by 20 percent due to lack of maintenance and is on a lot valued separately at $35,000. Using the cost approach formula:

Depreciation: 20% x $125,000
Property Value = $125,000– $25,000 + $35,000 = $135,000
The estimated value of the property based on the cost approach is $135,000.

☞ ***Example:***

A warehouse that would cost $350,000 to construct today has depreciated 25 percent in its lifetime and is on land valued at $11 0,000. What is the property's total estimated value by the cost approach?

Property Value = $350,000 – ($350,000 x 25%) + $110,000
$350,000 – $87,500 + $110,000 = $372,500

The estimated value of the property based on the cost approach is $372,500.

METHODS OF COST ESTIMATION

In this approach to appraisal, value is estimated and analyzed by determining reproduction or replacement cost, less depreciation, plus the value of the land as if it were vacant.

The selection of a method of cost estimation depends upon the type of depreciation analysis to be made. The more detailed methods of depreciation analysis require more detailed estimates of cost. Several of the most widely used methods are presented below in increasing order of complexity and costliness.

- **Comparative Unit Method** – In this method, cost estimates are made by grouping all the components together on a *Unit* basis, such as cost per square foot of building area or cost per cubic foot of building volume.

  This is the easiest method of cost estimation, and widely used in practice. However, it is the least accurate method, because costs are averaged out over the whole building.

  Because incurable physical deterioration can be estimated only on a lump–sum basis when this method is used, it cannot be used where a breakdown of the accrued depreciation estimate is required.

- **Unit–in–Place Method** –This method involves estimating the installed unit cost of materials or *component sections* of the structure. It accounts for the cost of both materials and the labor to put them in place, on a per unit basis.

  This method can be applied using the segregated cost data found in most cost manuals, with appropriate adjustments for time and location.

  An advantage of this method is that it simulates the procedures used by builders in preparing estimates, and is readily understandable, accurate, and widely used and accepted. However, it is detailed and time consuming.

- **Quantity Survey Method** – This is the most accurate method of cost estimation. It is also the most detailed, costly, and time–consuming, and should be attempted only by an expert. Due to the complexity of the method, its use is rarely justified in residential appraisal.

INCOME APPROACH

In the income approach, value is based on the rental income the property is capable of earning.

This income approach assumes that the value of property is indicated by the amount of income that the property can generate: the greater the income, the greater the value.

The income approach may use ***net operating income*** or *gross income*.

GROSS INCOME MULTIPLIERS (COMPARISON METHOD)

The use of gross income multipliers is an application of the market data approach. The Gross Income Multiplier (GIM) is a number which expresses the ratio between the sales price of a property and the gross rental income produced by that property at the time it is sold. Comparable sales properties for the gross income multiplier analysis are chosen in the same manner as sales comparables used in direct sales comparison analysis. The same salient features of the subject property which are accounted for in the direct sales comparison approach and the cost approach (location, physical characteristics, etc.) must be considered in the GIM analysis. At least 6 comparable sales properties should be included in the analysis; the use of 12 to 15 would be preferable. The comparable sales must be bona fide, arm's length transactions. All sales data must be reliable and verified by one of the principals. .

Adjustments should not be necessary if the comparable properties are really comparable to the subject if adjustments are necessary, they should be made in the same proportion for both sales prices and rents. The appraiser must take care not to adjust the sales price for time, without making any corresponding change in the rent

There is no standard gross income multiplier. The GIM varies according to property type, market conditions, and time. The appropriate gross income multiplier is determined by current conditions in the local market

The gross income multiplier is derived by dividing the value of the property by its annual gross monthly income (GI).

The GIM for a specific property is usually not rounded, except perhaps to the nearest whole number. Rounding is more likely and properly applied to the multiplier selected during the reconciliation. Gross rent multipliers are not adjusted.

Reconciliation. If the properties are truly comparable to the subject and to one another, their gross income multipliers should fall within a fairly narrow range. The appraiser then selects the appropriate gross income multiplier indicated by the pattern for the comparable properties. This is the GIM that will be applied to the estimated market rent of the subject property to derive an estimate of value.

GIM = Value / GI or Value = GI X GIM

☞***Example:***

This process would be carried out for each rental sales comparable (six comparables in this case). From the above process, a range of multipliers would result.

Example: 13, 13, 14, 14.5, 14.5, 14.5, 15.0

From the above example, we can see that 14.5 is the most likely multiplier.

If the monthly rent is $2000, then the value would be:

$2,000 x 12 x 14.5 = $348,000.

☞***Example***

If the sales price is $100,000 and the monthly rent is $400, the Gross Income Multiplier is $100,000 / (400 x 12) = 20.83

DISADVANTAGES OF USING GROSS INCOME MULTIPLIER

GIM is relatively simple to use and easy to understand. It is widely accepted. However, there are limits to its application.

- Gross rent multiplier analysis depends on an active rental market for residential properties. It may not work if there is insufficient reliable data. A lack of rental market activity may make it impossible to apply GIM analysis.

- Unusual market forces may distort the relationship between rents and sales prices. Rentals tend to be more sensitive to changes in the environment than owner–occupied properties; while a renter may leave on short notice, an owner usually cannot without financial loss. Sales prices are more sensitive to changes in zoning regulations, tax burden, and physical deterioration than rents are, especially where rent controls distort the relationship between rents and sales prices.

- It is not quite accurate as using an net operating income (discussed below). The gross income does not account for adjustment on the income losses due to factors like vacancies loss, operating expenses.

INCOME CAPITALIZATION

While the direct sales comparison and cost approaches are applicable to all types of properties, income capitalization is applicable only to investment real estate which is capable of producing money income and where the motivation of the buyers is a return on investment including income tax considerations.

- Income capitalization is the process of converting a series of anticipated future periodic installments of net income to their present worth or value. The use of income capitalization in real estate valuation is based on the premise that value is the present worth of anticipated or forecast future benefits in the form of money income.

- Income capitalization differs from gross income multiplier analysis (discussed below) in that net income, rather than gross income, is processed to a value estimate.

- Valuation is undertaken from the viewpoint of the typical informed investor and is based on the money income produced by the property. The market is stratified into comparable, competitive investments.

- **Investment Principles** – Investment analysis is essentially a matter of determining who gets what, and when. It points out the amount and timing of anticipated income, receipts, and expenses.

- More is preferable to less for income. The reverse is true for expenses and capital outlays. The investor would prefer to receive $5,000 rather than $500 on an investment

- Sooner is preferable to later for income. The reverse is true for expenses and capital outlays. Because a dollar received today is worth more than a dollar received a year from now, the investor prefers to receive income from the investment as soon as possible.

- The investor's primary concern is to maintain capital intact. This is return of investment, and means that the entire amount of the original investment is returned to the investor.

- The investor typically seeks a profit or gain on the investment, in addition to the return of deposit. This gain is referred to as the return on investment.

◆ The **capitalization rate** is a composite of the rate of return on the investment and the rate of return of the investment.

NET OPERATING INCOME

The ***income capitalization approach*** is based on the net income, or investment return, that a buyer expects from the property. The price that the buyer will pay will be determined by the probable return the property will yield from the investment.

Remember that the income capitalization approach is based on **net operating income,** which is usually expressed as an annual amount.

◆ Compute the net operating income (NOI) – From gross annual income a vacancy factor is subtracted to establish an **effective gross income**, from which annual operating expenses are subtracted to arrive at the projected future net operating income.

If a property's net operating income for the year is known, as well as the buyer's anticipated return for the investment (stated as a *capitalization rate*), value can be computed by using the following formula:

☞ ***Property Value = Net operating Income / Return (V = I / R)***

☞ **Example:**

A buyer wants a 9 percent investment return. He is interested in a medical office building that produces a net operating income of $22,500 per year. What would the buyer be willing to pay for the building?

$22,500 / 9% = $250,000

The property value necessary to produce the expected net operating income is $250,000.

The return that can be expected based on an estimated level of income and property value can be computed by using a variation of the basic income capitalization formula: Return = Income / Property Value

☞ **Example:**

An investor estimates that a net operating income of $39,600 can be received from a building that will require an investment of $360,000. What is the investor's capitalization rate (return)?

$39,600 / $360,000 = .11

The expected return, based on the income alone, is 11%.

A buyer who has only a certain amount to invest and wants a specific rate of return from his investment would use another variation of the formula:

Net Operating Income = Property Value x Return (I = V x R)

☞ **Example:**

To receive a 12 percent return from an investment of $100,000, what would be the required net operating income of the purchased property?

$100,000 x 12% = $12,000
The net operating income would have to be $12,000.

DETERMINING CAPITALIZATION RATE

The two most frequently used methods of deriving a capitalization rate are the comparative sales method and the band of investment method.

COMPARATIVE SALES

The comparative sales method of deriving an appropriate cap rate is based upon an analysis of recent sales of comparable properties. The indicated capitalization rate is derived by dividing the net income from the property by its sale price.

☞ ***Example:***

An apartment building with an annual net income of $75,000 recently sold for $750,000. The indicated capitalization rate is 10%. ($75,000 / $750,000 = .10 or 10%)

BAND OF INVESTMENT

The band of investment method derives a capitalization rate which is a composite of the rates of return required by the lender and by the owner of the equity interest. The rate of return required by the lender reflects the relative attractiveness of the loan compared with alternate permitted investments for the lender's funds. Similarly, the equity component reflects the competitive alternate returns to equity, both before and after taxes.

- **Mortgage Interest Technique**. The capitalization rate is computed as a weighted average of the most probable mortgage terms and the return required by the equity investor.

☞ ***Example:***

Assume that a long–term loan of 70% of the property value is available at 9% interest, and investors require 12% interest on the equity. What is the capitalization rate?

Interest	*Portion*	*Rate*	*Product*
First Mortgage	*.70 x*	*.09*	*=.063*
Equity	*.30 x*	*.12*	*=.036*
Capitalization Rate			*=.099 or 9.9%*

In the above example, the percentages are only for return on total property value. For appraisal use, a cap rate must also include a proper return of investment, reduced to cover improvements only, over their remaining economic life.

☞ ***Example***

An 80:20 building–to–land ratio is 80% depreciable. Assume a 25–year remaining economic life, or 4% yearly depreciation rate. 80% x 4% = 3.2% weighted depreciation rate. Add the result to a desired rate of return on investment to derive an overall rate. The capitalization rates must provide for both returns (of and on) in realty appraisal.

- **Mortgage Constant Technique** –This technique uses mortgage constants rather than the nominal interest rates used in the mortgage interest technique. A mortgage constant is the total annual payment of principal and interest, with level payment amortization, expressed as a percentage of the initial principal amount of the loan. Constants are found in published financial tables. This technique uses a weighted average of the mortgage constant and the return on equity required by investors.
  - Use of the mortgage constant technique provides for recapture (return of the investment) in addition to the return on the investment
  - This is the preferred method for arriving at an overall capitalization rate and is the one most used by both appraisers and investors. However, it should be noted that it assumes that the amortization of loan principal satisfies all of the capital recapture requirements.

☞ ***Example***

Assume a 75% loan for 25 years at 9.5% interest represents the prevailing financing terms. The mortgage constant for these figures is .104880. If investors require 12% return on equity, the capitalization rate is calculated as follows:

Interest	*Portion*	*Rate*	*Product*
First Mortgage	*.75 x*	*.104880*	*=.0786*
Equity	*.25 x*	*.12*	*=.03*
Overall Capitalization			*= .1086 or 0.86%*

Rate

(Mortgage constant: The total annual payment of principal and interest on a mortgage with level payment amortization, expressed as a percentage of the initial principal amount of the loan.)

RECONCILIATION

The appraiser must correlate and reconcile the estimated values for the final value estimate and decide what conclusions can be drawn from the volume of collected facts. The appraiser never simply averages differing value estimates. The most relevant approach, based on analysis and judgment, receives the greatest weight in determining the estimate that most accurately reflects the value sought.

RELATIONSHIP OF APPROACHES

The three approaches to real estate appraisal require different kinds of information, which may include data on comparable nearby property sales (sales comparison approach), building cost (cost approach), and investment return (income capitalization approach). The information available will help determine which of the appraisal methods will be given the most validity in the appraiser's final estimate of the market value of the subject property.

As a general rule, the sales comparison approach is the most reliable approach with single–family residences; the cost approach is most reliable with non–income–producing property having a limited market or with special purpose properties; and the income capitalization approach is most reliable with income–producing property.

Most appraisals will require the use of more than one approach, especially when land value must be distinguished from building value. This is true when the cost approach is used to find building value. There are other instances when land value must be separated from building value, such as for tax valuation purposes. These will be discussed later in this book.

The next step in the appraisal process is to analyze the value indications from the three approaches to arrive at the best and most supportable opinion of value. This can be either a single dollar figure or a range into which the value will most likely fall. The process the appraiser follows to do this is called reconciliation.

Proper analysis and reconciliation are essential to a good appraisal report. The use of accepted appraisal methods does not in itself produce a sound value estimate. It must be combined with good judgment on the part of the appraiser, as well as experience in gathering needed information and making thorough analyses and value interpretations of relevant data.

Each of the three approaches to value results in a separate indication of value for the subject property. In general, the greater the similarity among the three value indicators, the more reliable they are. However, it is very rare for all three value indicators to be identical. When the value indicators are not identical, the appraiser must somehow forge the value indicators into one estimate of value. This process is called reconciliation.

Reconciliation is the process of analyzing the appraisal problem, selecting the most appropriate method of the three and giving it the most weight in determining the final estimate of value.

Reconciliation is the easiest process when the value indicators are very similar.

In that case, it is usually safe to assume that the value of the property lies somewhere between the lowest value indicator and the highest.

> *Example: An appraiser arrives at the following value indicators:*
>
> *Cost Approach: $150,000*
> *Market Approach: $145,200*
> *Income Approach: $144,500*
>
> *Since the value indicators are reasonably similar to each other, the value of the property is probably somewhere between $144,500 (the lowest indicator) and $150,000 (the highest indicator).*

However, the process of reconciliation is *not* a simple averaging of the three value indicators. In fact, there is ***no*** set formula at all for reconciling the values. The process relies entirely on the judgment and ability of the appraiser to arrive at the most reliable estimate of value.

A primary consideration in the reconciliation process is the relative reliability of the three value indicators, especially when there is a wide disparity between the three indicators. For this reason, the reconciliation process requires a thorough review of the complete appraisal process. The appraiser must review the reliability of the data, the logic and analysis applied to the data, and the resulting value indicators.

In addition to reviewing and considering the reliability of the various value indicators, the appraiser will also consider the use of the appraisal. For example, all things being equal, more weight may be placed on the value indicated by the income approach in the case of an appraisal that will be used by an investor who is looking for income property. On the other hand, if the appraisal is being used to help the owner–occupant purchaser qualify for a home loan, the sales comparison data approach may be considered the most reliable.

Procedure for Qualifying a Property

Conventional Lenders

Conventional lenders use a less formal process than the FHA or DVA in qualifying the property. Typically, the applicant completes a loan application and presents it to the lender. The applicant is referred to a loan officer, who asks questions about the property to see if it meets the lender's policy. The loan officer also discusses the possible loan terms, such as loan–to–value ratio, interest rate, term, and loan fee. If the requested loan meets the lender's loan policy, the loan officer asks an appraiser to inspect the property.

Conventional lenders use both staff and fee appraisers. Commercial banks and savings banks use primarily staff appraisers. Mortgage companies mostly use fee appraisers. After an appraisal is completed, it is reviewed by the lender, which checks the appraisal for accuracy and completeness. In addition, the lender determines whether to proceed with the loan request. With the completed appraisal in hand, the lender is in a better position to make this decision. The lender checks the value of the property to make sure it is high enough to grant the loan. If the loan requested is based on a $480,000 sales price but the lender's appraisal is only $450,000, the lender can make a loan based on the lower amount, but not on the greater. If the property is acceptable and the value high enough to grant the loan, the lender will continue processing the loan. The next step would be to qualify the applicant. Later, a loan committee reviews both the property and the applicant. The final approval of the property rests with the committee.

FHA and DVA Property Standards

FHA and DVA requirements differ from most requirements for conventional loans. First let's discuss how the FHA and the DVA qualify property.

The Federal Housing Administration and the Department of Veterans Affairs do not operate like conventional lenders; they *insure* or *guarantee* loans. They have minimum property standards that all properties have to meet. Beyond that, the FHA and the DVA have no specific property requirements. They do not adjust the loan–to–value ratio because of the property – if the property meets the minimum standards, it will be entitled to the maximum loan. Likewise, the interest rate is not affected by the property. Lenders' rates and points for FHA and DVA are entirely negotiable.

QUALIFYING FOR FHA AND DVA

The primary responsibility of the FHA and the DVA is to ensure that a property meets their minimum property standards. In addition, they must establish a market value for the property. An FHA appraisal must be ordered through an approved FHA lender (commercial banks, savings banks, and most mortgage companies can be approved lenders). The lender orders an appraisal by filling out an FHA appraisal request form. On receipt of the request, the FHA will assign it to an FHA – qualified fee appraiser, an independent appraiser who works with lenders and the public.

After the appraiser has inspected and appraised the property, a ***conditional commitment*** is issued. The **"**conditional**"** includes any other conditions that the FHA is requiring, such as termite work and repairs, all of which must be completed before FHA insurance will be issued. A copy of the conditional commitment is sent back to the lender who ordered the appraisal.

The DVA operates in much the same way as the FHA. A DVA appraisal is ordered by filling out an appraisal request form. The appraisal can be ordered by anyone, but in practice is usually ordered by a DVA–qualified lender. The appraisal request is sent to the DVA, which in turn gives it to an independent fee appraiser who is DVA qualified. The DVA uses fee appraisers for all its field work. It does have full–time staff appraisers, but their function is to act as reviewers and supervisors. Once the fee appraiser has completed the appraisal, it is sent to the DVA office for review. If it is approved, the next step is to issue a ***Certificate of Reasonable Value (CRV),*** which also includes other conditions and repairs that the DVA requires on the property. A copy of the CRV is mailed to the one who ordered it and to the veteran–buyer.

FINAL MARKET VALUE

Once the appraiser has completed the three approaches to value, the next step is to arrive at a final estimate of value. This process is called ***final reconciliation****.* The appraiser begins the process by analyzing the strengths and weaknesses of each approach to determine which approach will give the most reliable answer.

In the appraisal of single–family properties, more weight is given to the sales comparison or market approach because it is the most reliable. The cost approach is not as reliable, because it is difficult to estimate depreciation and to determine the value of land in a built–up neighborhood. The cost approach is best used for special–purpose properties such as churches, schools, government buildings, and anything unusual that does not sell routinely in the marketplace. The use of a gross income multiplier is seldom used in appraising a single–family property, because typical buyers do not buy them for income purposes.

Next, the appraiser analyzes the data used in the report for completeness and reliability. The final step is to arrive at market value. Again, this is not an averaging process, but one in which the appraiser evaluates each approach, then selects a single estimate of value.

TITLE INSURANCE

A preliminary title report is a report on the condition of title prepared in anticipation of closing and prior to issuance of a title insurance policy.

- **Who Owns What** – A lender accepting a security interest in real property has to be certain that the borrower has and can convey to the lender an insurable interest in the property.
- **Lender's Coverage Required** – A lender's title requirements include protection against any problems that affect the value of the loan security.

TYPES OF POLICIES

There are two types of title insurance policies: the standard policy and the extended policy.

STANDARD TITLE POLICY (CLTA)

The "**standard**" policy is the most widely used, and generally:

- Insures the owner for the amount of the purchase price.
- Insures the lender for the amount of the loan.

Standard policy is frequently referred to as a CLTA (acronym for California Land Title Association), a state trade association for title insurance companies. This standard policy insures the lender only unless the owner requests and pays for owner coverage.

This policy protects against:

1. Matters of public record. Acknowledged documents are recorded in the county where the property is located. Sources for searching for documents are city, county, state and federal, i.e.,:
    - Federal land offices.
    - State of California Secretary of State.
    - Taxing authorities.
    - Special assessment districts.
    - County Clerk's Office.
    - Anyone having an interest in due property.
2. Forgery.
3. Impersonation or lack of capacity of a party to a transaction. For example, transaction with a minor.
4. Defective delivery of a recorded grant deed.

Under standard policy, the title company does not make a physical inspection of the property and therefore excludes the following:

- It does not protect against unrecorded easements and liens, encroachments or rights of parties in possession.
- Changes in land use dictated by zoning ordinances.
- Mining claims and water rights.

EXTENDED POLICY (ALTA)

Other risks can be ascertained by an on-site inspection of the property and a survey. Extended coverage is established and normally required by lenders. If the owner wants additional perils covered, extended coverage or a special endorsement can be added to cover these risks.

An **ALTA extended coverage lender's policy** includes standard coverage provisions plus:

- Incorrect survey of property boundary lines or size of lot.
- Violations of recorded covenants, conditions, and restrictions.
- Encroachments of improvements onto existing easements.
- Any unrecorded easement rights disclosed by inspection.
- The rights of other parties, possessory or otherwise, disclosed by inspection.
- Unrecorded leases of tenants occupying the land.
- Unrecorded assessments as disclosed by public works activity in the area and inspection of tax office records (if work is in progress).
- Unrecorded claims resulting from work performed or materials provided for recent improvement of the land.

The extended coverage policy is commonly referred to as an ALTA (American Land Title Association) policy. The ALTA policy, which includes a competent survey or physical inspection, is usually required by California and out-of-state lenders who are not able to make a personal, physical inspection of the property. The borrower pays for this policy.

No policy will protect against defects known to the insured or against government regulations concerning occupancy and use (zoning).

ALTA-R

The ALTA-R policy is recommended by title companies, for one-to-four owner-occupied residential dwellings. It does not include a survey because the property lines are already established by a recorded subdivision map. Since the title companies do not have to do a survey, it gives the buyer more coverage for the same price. The CAR deposit receipt includes the ALTA-R as the preferred residential title policy choice.

Hazard Insurance

An insurance policy is a contract in which the insurer agrees to indemnify the insured against losses caused by an unknown or contingent event.

- **Lender's Risk** – If the value of a secured property is reduced by some event, the lender's security is proportionally diminished. The lender reduces this risk by requiring that it be named as the beneficiary in a risk insurance policy.
- **Perils Covered** – The lender will require insurance against loss not only by the hazards of fire and lightning, but also most likely the additional perils of windstorm, hail, aircraft, riot, vehicles, explosion, and smoke.

Form 12-1: Sample Uniform Residential Appraisal Report (partial – 3 pages)

Speedy Appraisal Services

Property Description **UNIFORM RESIDENTIAL APPRAISAL REPORT** **File No.** 1462Saska

SUBJECT

Property Address 1462 Saskatchewan Dr. City Sunnyvale State CA Zip Code 94087
Legal Description Tract 3821, Lot 56 County Santa Clara
Assessor's Parcel No. 323-29-071 Tax Year 2001 R.E. Taxes $ 6,854.38 Special Assessments $ N/A
Borrower Chen Wen-Jei & Yu Ying L. Current Owner Same Occupant: [X] Owner [ ] Tenant [ ] Vacant
Property rights appraised [X] Fee Simple [ ] Leasehold Project Type [ ] PUD [ ] Condominium (HUD/VA only) HOA$ N/A /Mo.
Neighborhood or Project Name N/A Map Reference 832-D4 Census Tract 5083.04
Sale Price $ Refinance Date of Sale N/A Description and $ amount of loan charges/concessions to be paid by seller N/A
Lender/Client Chesapeake - EMail Address 30030 Mission Blvd. # 216, Hayward, CA 94544
Appraiser Dynasty Appraisal Address 4907 Colusa St., Union City, CA 94587

NEIGHBORHOOD

Location	[ ] Urban	[X] Suburban	[ ] Rural	**Predominant occupancy**	**Single family housing** PRICE $ (000)	AGE (yrs)	**Present land use %**		**Land use change**
Built up	[X] Over 75%	[ ] 25-75%	[ ] Under 25%				One family	95%	[X] Not likely [ ] Likely
Growth rate	[ ] Rapid	[X] Stable	[ ] Slow	[X] Owner 95%	400 Low	10	2-4 family	2%	[ ] In process
Property values	[ ] Increasing	[X] Stable	[ ] Declining	[ ] Tenant	1100 High	60	Multi-family	1%	To:
Demand/supply	[ ] Shortage	[X] In balance	[ ] Over supply	[X] Vacant (0-5%)	Predominant		Commercial	2%	
Marketing time	[X] Under 3 mos.	[ ] 3-6 mos.	[ ] Over 6 mos.	[ ] Vacant (over 5%)	600	30	( )		

Note: Race and the racial composition of the neighborhood are not appraisal factors.

Neighborhood boundaries and characteristics: The subject neighbourhood is bounded by El Camino Real to the north, Interstate 280 to the south, Highway 85 to the west, Wolfe Rd. to the east.

Factors that affect the marketability of the properties in the neighborhood (proximity to employment and amenities, employment stability, appeal to market, etc.): At this time, there are no factors affecting the marketability of neighbourhood properties. The subject property is located in southern area of City of Sunnyvale. Homes in the area are of good to average quality/construction and are displaying typical care and maintenance. The subject property is located in close proximity to Fremont High School, Homestead Hospital and Homestead Square . Interstate 280 approximately 3/4 mile south, offers good access to the employment area of South Bay.

Market conditions in the subject neighborhood (including support for the above conclusions related to the trend of property values, demand/supply, and marketing time -- such as data on competitive properties for sale in the neighborhood, description of the prevalence of sales and financing concessions, etc.): Concessions are not prevalent. Marketability for the area is good with reasonably priced listings selling within 1 to 3 months. Home values are stable over past couple months.

PUD

Project Information for PUDs (If applicable) -- Is the developer/builder in control of the Home Owners' Association (HOA)? [ ] YES [X] NO
Approximate total number of units in the subject project N/A . Approximate total number of units for sale in the subject project N/A
Describe common elements and recreational facilities: N/A

SITE

Dimensions 94.78X85
Site area 8,056 Sq.Ft. Corner Lot [ ] Yes [X] No
Specific zoning classification and description R1 (Residential)
Zoning compliance [X] Legal [ ] Legal nonconforming (Grandfathered use) [ ] Illegal [ ] No zoning
Highest & best use as improved: [X] Present use [ ] Other use (explain)

Topography Basically Level
Size Typical for area
Shape Rectangular
Drainage Appears adequate
View None
Landscaping Typical
Driveway Surface Concrete
Apparent easements None apparent
FEMA Special Flood Hazard Area [ ] Yes [X] No
FEMA Zone BX Map Date 12/19/1997
FEMA Map No. 0603520001D

Utilities	Public	Other	**Off-site Improvements**	Type	Public	Private
Electricity	[X]		Street	Asphalt	[X]	[ ]
Gas	[X]		Curb/gutter	Concrete	[X]	[ ]
Water	[X]		Sidewalk	Concrete	[X]	[ ]
Sanitary sewer	[X]		Street lights	Standard	[X]	[ ]
Storm sewer	[X]		Alley	None Noted	[ ]	[ ]

Comments (apparent adverse easements, encroachments, special assessments, slide areas, illegal or legal nonconforming zoning, use, etc.): No apparent adverse easements, encroachment or conditions noted.

DESCRIPTION OF IMPROVEMENTS

GENERAL DESCRIPTION		EXTERIOR DESCRIPTION		FOUNDATION		BASEMENT		INSULATION	
No. of Units	One	Foundation	Concrete	Slab	No	Area Sq.Ft.	0	Roof	Cncld [X]
No. of Stories	One	Exterior Walls	Stucco	Crawl Space	Yes	% Finished	N/A	Ceiling	Cncld [X]
Type (Det./Att.)	Detached	Roof Surface	Asph. Sh.	Basement	N/A	Ceiling	N/A	Walls	Cncld [X]
Design (Style)	Ranch	Gutters & Dwnspts.	Gal Alum.	Sump Pump	N/A	Walls	N/A	Floor	Cncld [X]
Existing/Proposed	Existing	Window Type	Sld. Alum.	Dampness	None noted	Floor	N/A	None	[ ]
Age (Yrs.)	37	Storm/Screens	Thermo/Yes	Settlement	None noted	Outside Entry	N/A	Unknown	[ ]
Effective Age (Yrs.)	25	Manufactured House	No	Infestation	None noted				

ROOMS	Foyer	Living	Dining	Kitchen	Den	Family Rm.	Rec. Rm.	Bedrooms	# Baths	Laundry	Other	Area Sq.Ft.
Basement												
Level 1	1	1	1	1		1		1	1	1		1,265
Level 2								4	2			960

Finished area **above** grade contains: 9 Rooms; 5 Bedroom(s); 3 Bath(s); 2,225 Square Feet of Gross Living Area

INTERIOR	Materials/Condition	HEATING		KITCHEN EQUIP.		ATTIC		AMENITIES			CAR STORAGE:	
Floors	Hd/Carpet/Good	Type	FWA	Refrigerator	[ ]	None	[ ]	Fireplace(s) #	1	[X]	None	[ ]
Walls	Painted/Good	Fuel	Gas	Range/Oven	[X]	Stairs	[ ]	Patio	Concrete	[X]	Garage 2	# of cars
Trim/Finish	Wood Trim/Good	Condition	Avg.	Disposal	[X]	Drop Stair	[ ]	Deck	Wood	[X]	Attached	2 Cars
Bath Floor	Tile/Carpet/Good	COOLING		Dishwasher	[X]	Scuttle	[X]	Porch	Covered	[X]	Detached	
Bath Wainscot	Fiberglass	Central	None	Fan/Hood	[X]	Floor	[ ]	Fence	Wood	[X]	Built-In	
Doors	Ext-Solid Wood	Other	None	Microwave	[ ]	Heated	[ ]	Pool	None	[ ]	Carport	
	In-Hollow Wood	Condition		Washer/Dryer	[ ]	Finished	[ ]			[ ]	Driveway	2Cars

Additional features (special energy efficient items, etc.): None

COMMENTS

Condition of the improvements, depreciation (physical, functional, and external), repairs needed, quality of construction remodeling/additions, etc.: The subject property is in average physical condition. No physical, external or functional inadequacies were noted at time of inspection.

Adverse environmental conditions (such as, but not limited to, hazardous wastes, toxic substances, etc.) present in the improvements, on the site, or in the immediate vicinity of the subject property: There no adverse environmental condition were noted by the appraiser on the site, in the improvements, or the immediate vicinity at the time of inspection.

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Speedy Appraisal Services

Valuation Section

UNIFORM RESIDENTIAL APPRAISAL REPORT

File No. 1462Saska

COST APPROACH

ESTIMATED SITE VALUE		= $	600,000
ESTIMATED REPRODUCTION COST-NEW OF IMPROVEMENTS:			
Dwelling	2,225 Sq. Ft. @ $ 125.00	= $	278,125
Bsmt. 0	Sq. Ft. @ $	=	0
Patio		=	10,000
Garage/Carport	489 Sq. Ft. @ $ 20.00	=	9,780
Total Estimated Cost New		= $	297,905
Less: 25 Physical, Functional, External	Est. Remaining Econ. Life: 50		
Depreciation $83,466		= $	83,466
Depreciated Value of Improvements		= $	214,439
"As-is" Value of Site Improvements		= $	20,000
INDICATED VALUE BY COST APPROACH		= $	834,400

Comments on Cost Approach (such as, source of cost estimate, site value, square foot calculation and for HUD, VA and FmHA, the estimated remaining economic life of the property): The high land to improvements ratio is typical of properties in this area. Costs were obtained from Marshall & Swift Handbook and local contractors. Land value is derived extraction. Depreciation determined by the overall condition of the unit as related to normal wear and tear and average condition of comparable residences in the area.

SALES COMPARISON ANALYSIS

ITEM	SUBJECT	COMPARABLE NO. 1		COMPARABLE NO. 2		COMPARABLE NO. 3	
Address	1462 Saskatchewan Dr. Sunnyvale, CA 94087	627 Oneida Dr. LP: $ 869,000 DOM: 11		650 Princeton Dr. LP: $ 850,000 DOM: 35		783 Steuben Dr. LP: $ 869,000 DOM: 11	
Proximity to Subject		0.65 Mi		0.7 Mi		0.75 Mi	
Sales Price	$ Refinance		$ 861,000		$ 868,000		$ 869,500
Price/Gross Liv. Area	$ 0.00 ☑	$ 379.30 ☑		$ 382.38 ☑		$ 391.49 ☑	
Data and/or Verification Sources	Appraiser Inspection	Win2Data/NDC/MLS# 214524 Doc # 16239853		Win2Data/NDC/MLS#206562 Doc # 16152676		Win2Data/NDC/MLS#207802 Doc # 16184304	
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	+(-)$ Adjustment	DESCRIPTION	+(-)$ Adjustment	DESCRIPTION	+(-)$ Adjustment
Sales or Financing Concessions	N/A	Conventional None		Conventional None		Conventional None	
Date of Sale/Time	N/A	04/30/2002 COE		03/13/2002 COE		03/29/2002 COE	
Location	Suburban	Suburban		Suburban		Suburban	
Leasehold/Fee Simple	Fee Simple	Fee Simple		Fee Simple		Fee Simple	
Site	8,056 Sq.Ft.	6,000 Sq.Ft	+10,000	6,100 Sq.Ft	+9,000	7,954 Sq.Ft	+500
View	None	None		None		None	
Design and Appeal	Ranch	Ranch		Ranch		Ranch	
Quality of Construction	Average	Average		Average		Average	
Age	37 Yrs.	37 Yrs.		36 Yrs.		26 Yrs.	-10,000
Condition	Good	Average	+20,000	Good/Average	+10,000	Average	+20,000
Above Grade Room Count (Total / Bdrms / Baths)	9 / 5 / 3.00	9 / 5 / 3.00		10 / 5 / 3.00		9 / 4 / 2.50	+7,000
Gross Living Area	2,225 Sq.Ft.	2,270 Sq.Ft.		2,270 Sq.Ft.		2,221 Sq.Ft.	
Basement & Finished Rooms Below Grade	0 Sq.Ft. None	0 Sq.Ft. None		0 Sq.Ft. None		0 Sq.Ft. None	
Functional Utility	Standard	Standard		Standard		Standard	
Heating/Cooling	Gas FWA	Gas FWA/No AC		Gas FWA/No AC		Gas FWA/No AC	
Energy Efficient Items	Standard	Standard		Standard		Standard	
Garage/Carport	2 Cars Att. Gar.	2 Cars Att. Gar.		2 Cars Att. Gar.		2 Cars Att. Gar.	
Porch, Patio, Deck, Fireplace(s), etc.	Porch,Patio,Deck 1 Fireplace	Porch/Patio 1 Fireplace		Porch/Patio 1 Fireplace		Porch/Patio 1 Fireplace	
Fence, Pool, etc.	Fence/No Pool	Fence/ Pool	-10,000	Fence/No Pool		Fence/No Pool	
APN #	323-29-071	201-28-001					
Net Adj. (total)		[X] + [ ] -	$ 20,000	[X] + [ ] -	$ 19,000	[X] + [ ] -	$ 17,500
Adjusted Sales Price of Comparable		Gross: 4.6% Net: 2.3%	$ 881,000	Gross: 2.2% Net: 2.2%	$ 887,000	Gross: 4.3% Net: 2.0%	$ 887,000

Comments on Sales Comparison (including the subject property's compatibility to the neighborhood, etc.): All comps are resales of similar design, age, quality, condition and appeal from subject's market area.
Most weight is given to comp # 1 with support from comp # 2, 3 and 4.

ITEM	SUBJECT	COMPARABLE NO. 1	COMPARABLE NO. 2	COMPARABLE NO. 3
Date, Price and Data Source for prior sales within year of appraisal	No prior sales within 12 months as per Win2Data	No prior sales other than above as per Win2Data	No prior sales other than above within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data

Analysis of any current agreement of sale, option, or listing of the subject property and analysis of any prior sales of subject and comparables within one year of the date of appraisal: The appraiser is not aware of any sale, option or listing on the subject property within last 12 months at all.

INDICATED VALUE BY SALES COMPARISON APPROACH $ 881,000

INDICATED VALUE BY INCOME APPROACH (If Applicable) Estimated Market Rent $ N/A /Mo. x Gross Rent Multiplier N/A = $ N/A

RECONCILIATION

This appraisal is made [X] "as is" [ ] subject to the repairs, alterations, inspections or conditions listed below [ ] subject to completion per plans and specifications.

Conditions of Appraisal: No condition noted.

Final Reconciliation: Most emphasis is on the market comparison approach which considers area of similar properties within subject's neighbourhood. Cost approach is supportive. Income approach is not applicable.

The purpose of this appraisal is to estimate the market value of the real property that is the subject of this report, based on the above conditions and the certification, contingent and limiting conditions, and market value definition that are stated in the attached Freddie Mac Form 439/Fannie Mae Form 1004B (Revised 6/93).

I (WE) ESTIMATE THE MARKET VALUE, AS DEFINED, OF THE REAL PROPERTY THAT IS THE SUBJECT OF THIS REPORT, AS OF June 22, 2002 (WHICH IS THE DATE OF INSPECTION AND THE EFFECTIVE DATE OF THIS REPORT) TO BE $ 881,000 .

APPRAISER:	SUPERVISORY APPRAISER (ONLY IF REQUIRED):
Signature	Signature [ ] Did [X] Did Not Inspect Property
Name Dynasty Appraisal	Name Jerry Fung
Date Report Signed June 23, 2002	Date Report Signed June 23, 2002
State Certification # State	State Certification # AR023677 State CA
Or State License # AT028604 State CA	Or State License # State

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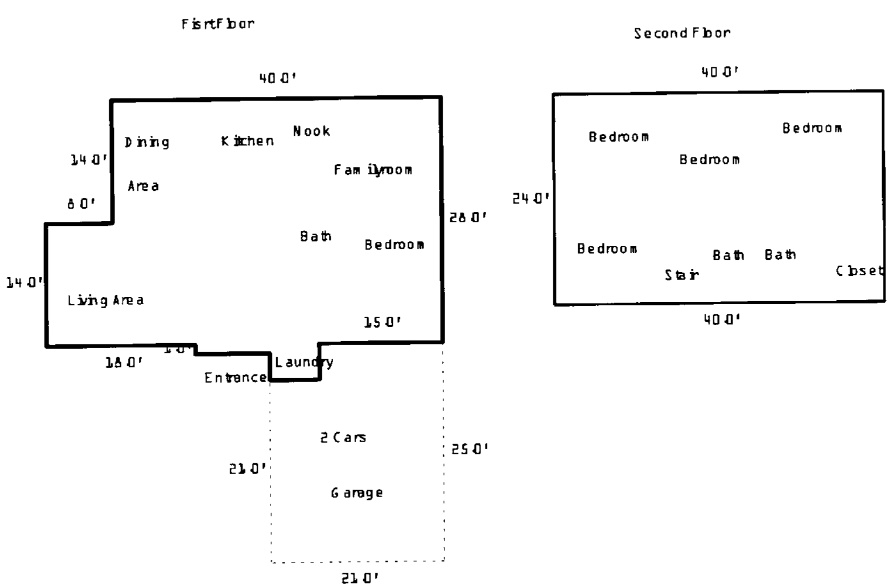
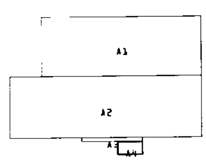
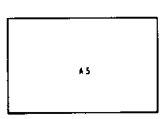
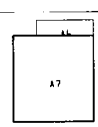
Polaroid Digital Solutions, Inc.

FLOORPLAN

Borrower:	Chen Wen-Jei & Yu Ying L.	File No.:	1462Saska
Property Address:	1462 Saskatchewan Dr.	Case No.:	
City: Sunnyvale		State: CA	Zip: 94087
Lender: Chesapeake - EMail			



SKETCH CALCULATIONS

	A1 : 40.0 x 14.0 =	560.0
	A2 : 48.0 x 14.0 =	672.0
	A3 : 15.0 x 1.0 =	15.0
	A4 : 6.0 x 3.0 =	18.0
	First Floor	1265.0
	A5 : 40.0 x 24.0 =	960.0
	Second Floor	960.0
	Total Living Area	2225.0
	A6 : 15.0 x 4.0 =	60.0
	A7 : 21.0 x 21.0 =	441.0
	Attached Garage	501.0
	Total Garage Area	501.0

PLANNED UNIT DEVELOPMENTS AND CONDOMINIUMS

In recent years, many ***planned unit developments (PUDs)*** and ***condominiums*** have been built in the United States. As more are built and resales occur, it is important that you know what they are and how they are appraised. It is important because some lenders have different loan policies on PUDs and condominiums as opposed to single–family homes.

A PUD or condominium is a type of property ownership, not a type of structure. A PUD refers to separate, individual fee ownership of a lot and home or townhouse. In addition, you own a proportionately undivided interest jointly with others in the development of the common areas and recreational facilities, if any. It is sometimes called a townhouse development. However, the term *townhouse* refers to the architecture and not the type of ownership. A PUD could be a group of single–family homes if there were joint ownership of a common area. In a PUD, there is no one living in the "airspace" above anyone else.

A condominium is a type of development in which a person owns a specified residential unit (three–dimensional airspace), together with an undivided interest in all the land including recreational facilities. A condominium may be part of a high rise, attached townhouse, or even a single–family detached development. In a legal sense, a condominium owner acquires a fee title interest in the airspace of the particular unit and an undivided interest (with the other condominium owners) in the land plus all other common areas such as hallways, elevators, utility rooms, carports, and recreational facilities.

Both PUDs and condominiums have homeowner association groups that are responsible for the management of the development. These groups meet regularly and are governed by specific regulations. It is the association's responsibility to maintain the common areas. It also sets the dues that each owner must pay in order to maintain the common areas and the exteriors of the individual structures.

☞ ***PUDs and condominiums present special appraising and lending problems. Lenders are concerned about the entire project as well as the value of a single unit within the project.***

A lender appraising a PUD or condominium unit is interested in more than just that particular unit. The lender is interested in the overall project, because the value of one unit is affected by the quality and the operation of the entire project. When a lender appraises a PUD or condominium, these are some of the items checked:

- General appearance of project
- Maintenance of common areas
- Amount of monthly homeowner dues, which should include reserves
- Recreational facilities that are adequate and well maintained
- adequate parking for owners and guests

A unit in a PUD or condominium is appraised basically the same way as a single–family dwelling. The appraiser uses the three approaches to value and relies primarily on the market data approach in arriving at a final value.

☞ INTERNET WEB LINKS

www.arri–assoications.org	American Society of Farm managers and Rural Appraisers
www.appraisalinstitute.org	Appraisal Institute
www.aicanada.org	Appraisal Institute of Canada
www.orea.ca.gov	California Office of Real Estate Appraisers
www.frea.com	Foundation of Real Estate Appraisers
www.nahb.com	National Association of Home Builders
www.naifa.com	National Association of Independent Fee Appraisers
www.iami.org/narea.html	National Association of Real Estate Appraisers
www.appraisalfoundation.org	The Appraisal Foundation

CHAPTER QUIZ

I. Which of the following is the *easiest* method of cost estimation to understand and apply?

A Segregated costs
B Quantity survey
C Unit–in–place
D Square foot

2. The most detailed method of estimating cost *new* is the:

A. Quantity survey method
B. Unit–in–place method
C. Segregated cost method
D. Square foot method

3. The basic capitalization formula is:

A V= I / R
B V= F / R
C V = I / F
D V = R / I

4. Which of the following statements is correct?

A. A quantity survey estimate requires a separate calculation of building materials and labor
B. Square foot or cubic foot building costs are derived from local contractors, the analysis of recently constructed buildings, or cost manuals
C. Unit–in–place costs refer to the combined cost of material and labor to construct each functional unit of the structure
D. All of the above

5. Property surveys sometimes discover problems in all of the following categories, ***except***

A. legal descriptions.
B. restrictions.
C. easements.
D. encroachments.

6. In reviewing the data collected for the income approach, the appraiser should check the mathematical accuracy of:

A. Gross income estimate
B. Allowance for vacancy and collection losses
C. Operating expense estimate
D. All of the above

7. What is the most detailed and reliable method for estimating construction costs?

A. Unit-in-place method
B. Quantity survey method
C. Asking the contractor
D. None of the above

8. The cost approach requires an estimate of the:

A. Land value and
B. Site improvements and building costs
C. Depreciation allowance
D. All of the above

9. When using the Income Approach, the appraiser assumes that:

A. Value is a function of income
B. Buyers estimate the duration of income when purchasing Income property
C. Future income is less valuable than present income
D. All of the above

10. Operating expenses of an apartment building may include all of the following, ***except***:

A. Salaries
B. Electricity
C. Management fees
D. Interest

Answer Key: 1–D, 2–A, 3–A, 4–C, 5–B, 6–D, 7–B, 8–D, 9–A, 10–D

CHAPTER 13: QUALIFYING THE BORROWER

PREVIEW

The second step in undertaking the risk (rendering the underwriting decision) of lending money on the basis of residential real estate collateral is analyzing the borrower's qualification. In consideration of the varying guidelines established not only by the secondary market, but FHA, VA, and the California Housing Agency in addition to the financial institution's lending policies. The determination of what guidelines apply is dependent upon the type of financing sought by the borrower. Both information required for loan qualification and the various forms involved will be discussed in this chapter as a means of outlining the procedure required to render a proper underwriting decision.

Real estate licensees can spend consider able effort in showing homes to potential clients. If these clients have not been pre qualified, this effort may be meaningless.

CREDIT AS MONEY

A prospective buyer with enough money can buy anything desired that is available in the market. Very few people could buy real estate if it had to be bought with cash. The "qualified" homebuyer, however, can buy with credit. Credit is a Latin–based word meaning "to trust" or "to believe." A banker will lend you money based on the belief that you will pay it back. The banker grants you "credit." Sometimes the money a banker loans you is "paper money" but usually it is "credit money" or "check money." We are all familiar with "check money." This is a written instruction to your banker to pay money (paper or credit) to someone else. Throughout the entire series of complicated transactions it is customary that no actual money (paper money or coin) changes hands at all–it is all handled by the bookkeeping activities of the bank (or banks, if there is more than one bank involved, as is usually the case). From the consumer's viewpoint, credit is like money–both confer power to purchase goods and services. Lacking money, a consumer who has credit can nevertheless buy today. Credit and credit rating will be discussed in more details in later of this chapter.

THE FINANCING CONTINGENCY

It has been estimated that approximately 99% of real estate purchase contracts contain financing contingencies. A buyer making an offer describes in some detail the financing proposed, and conditions the offer upon obtaining financing within the limits described. Typically the buyer then agrees **"**to act diligently and in good faith to obtain all applicable financing.**"** If the proposed financing is not available, the contingency fails and the entire contract falls.

DEPOSIT RECEIPT

Form 13–1 is a portion of the first page of a CAR standard form deposit receipt available for use throughout California, identifying financing contingencies.

Form 13-1: Purchase Agreement (partial)

CALIFORNIA ASSOCIATION OF REALTORS®

RESIDENTIAL PURCHASE AGREEMENT AND JOINT ESCROW INSTRUCTIONS (AND RECEIPT FOR DEPOSIT)

For Use With Single Family Residential Property — Attached or Detached

Date ______________________, at ____, California.

1. **OFFER:**
   A. **THIS IS AN OFFER FROM** _________________________________, _________________________________ ("Buyer").
   B. **THE REAL PROPERTY TO BE ACQUIRED** is described as __, , ____
   ____, Assessor's Parcel No. ____________________,
   situated in ____________________________, County of ____________________________, California, ("Property").
   C. **THE PURCHASE PRICE** offered is ____
   ____ Dollars $ __________________.
   D. **CLOSE OF ESCROW** shall occur __________ **Days** After Acceptance (or ☐ on ________________________________ (date)).
2. **FINANCING:** Obtaining the loans below **is a contingency** of this Agreement unless: (i) either 2H or 2I is checked below or (ii) otherwise agreed. Buyer shall act diligently and in good faith to obtain the designated loans. Obtaining deposit, down payment and closing costs **is not a contingency**.
   A. **BUYER HAS GIVEN A DEPOSIT TO THE AGENT SUBMITTING THE OFFER** .... $ ________________
   (or to ☐ ______________________________________), made payable to ____________________________
   by Personal Check, or ☐ ____, which shall be held uncashed
   until Acceptance and then deposited within **3 business days** after Acceptance or
   ☐ ____,
   ☐ with Escrow Holder, ☐ into Broker's trust account, or ☐ ____.
   Buyer represents that funds are good when deposited with Escrow Holder.
   B. **INCREASED DEPOSIT** shall be deposited by Buyer with Escrow Holder within ________ **Days** After Acceptance, ... $ ________________
   or ☐ ____.
   C. **FIRST LOAN IN THE AMOUNT OF** .... $ ________________
   (1) NEW First Deed of Trust in favor of LENDER, encumbering the Property, securing a note payable at maximum interest of ________________ % fixed rate, or ________________ % initial adjustable rate with a maximum interest rate cap of ______________%, balance due in______ years, amortized over ________ years. Buyer shall pay loan fees/points not to exceed ________________________. (These terms apply whether the designated loan is conventional, FHA or VA.)
   (2) ☐ FHA, ☐ VA: (The following terms only apply to the FHA or VA loan which is checked.)
   Seller shall pay (i) __________ % discount points, (ii) other fees not allowed to be paid by Buyer, not to exceed $ ________________, and (iii) the cost of lender required Repairs not otherwise provided for in this Agreement, not to exceed $____________________________.
   (Actual loan amount may increase if mortgage insurance premiums, funding fees or closing costs are financed.)
   D. **ADDITIONAL FINANCING TERMS:** ____ .. $ ________________
   ____
   ____
   ☐ Seller financing, (C.A.R. Form SFA-11); ☐ junior financing; ☐ assumed financing (C.A.R. Form PAA-11).
   E. **BALANCE OF PURCHASE PRICE** (not including costs of obtaining loans and other closing costs) to be deposited.. $ *0.00*
   with Escrow Holder within sufficient time to close escrow.
   F. **TOTAL PURCHASE PRICE** .... $ *0.00*
   G. **LOAN CONTINGENCY** shall remain in effect until the designated loans are funded (**or** ☐ __________ **Days** After Acceptance, by which time Buyer shall give Seller written notice of Buyer's election to cancel this Agreement if Buyer is unable to obtain the designated loans. If Buyer does not give Seller such notice, the contingency of obtaining the designated loans shall be removed by the method specified in paragraph 14).
   H. ☐ **NO LOAN CONTINGENCY:** (If checked) Obtaining any loan in paragraphs 2C, 2D or elsewhere in this Agreement is not a contingency of this Agreement. If Buyer does not obtain the loan, and as a result Buyer does not purchase the Property, Seller may be entitled to Buyer's deposit or other legal remedies.
   I. ☐ **ALL CASH OFFER:** (If checked) No loan is needed to purchase the Property. Buyer shall, within **5** (**or** ☐ ______________) **Days** After Acceptance, provide Seller written verification of sufficient funds to close this transaction. Seller may cancel this Agreement in writing within **5 Days** After (i) time to provide verification expires, if Buyer fails to provide verification or (ii) receipt of verification, if Seller reasonably disapproves it.
   J. **LOAN APPLICATIONS; PREQUALIFICATION:** Within **5** (**or** ☐ _________) **Days** After Acceptance, Buyer shall provide Seller a letter from lender or mortgage loan broker stating that, based on a review of Buyer's written application and credit report, Buyer is prequalified for the NEW loan indicated above. If Buyer fails to provide such letter within that time, Seller may cancel this Agreement in writing.
   K. ☐ **APPRAISAL CONTINGENCY:** (If checked) This Agreement is contingent upon Property appraising at no less than the specified total purchase price. If there is a loan contingency, the appraisal contingency shall remain in effect until the loan contingency is removed. If there is no loan contingency, the appraisal contingency shall be removed within **10** (**or** ☐ ________) **Days** After Acceptance.

Buyer and Seller acknowledge receipt of a copy of this page.
Buyer's Initials (________) (________)
Seller's Initials (________) (________)

EQUAL HOUSING OPPORTUNITY

Reviewed by Broker or Designee ____________ Date ____________

REVISION DATE 10/2000
RPA-11 (PAGE 1 OF 8) **RESIDENTIAL PURCHASE AGREEMENT (RPA-11 PAGE 1 OF 8)**

Agent: jerry fung **Prepared using WINForms® software**
Broker: JF 2373 S Hacienda Blvd , Hacienda Heights CA 91745

WHY PREQUALIFY THE BUYER?

Many real estate salespersons wait for the lender to qualify the borrower (after the buyer has selected a home to purchase) and hope that their buyer will qualify for the loan. The real estate professional in his or her first visit with the buyer can, however, gather information that will aid the professional in qualifying the prospective buyer. This qualification of the buyer is a help not only to the real estate salesperson, but also to the buyer. The buyer will have a better idea of the maximum mortgage amount that he or she can support with his or her present income.

Once the maximum mortgage is established and the buyer has determined the amount of money available for a down payment, the maximum sales price of a home that the prospective buyer can afford can be calculated. To establish the maximum sales price, the maximum loan amount and the amount of down payment are added together. For example, in your meeting with a prospective buyer, you learn that the maximum conventional loan your buyer can afford is $200,000 and he or she has $25,000 for the down payment. The maximum sales price is $225,00. You should explain to the buyer that the maximum loan amount is based on the current guidelines of the lenders in the area, not just your own guidelines, and for the prospective buyer to afford a home with a higher sales price, he or she must either make a larger down payment or be able to establish the existence of additional income that will meet the lenders guidelines. Once again, you have informed the buyer as to the maximum affordable house price. If the buyer wishes to purchase a higher priced house, the buyer must meet the requirements mentioned.

In addition to knowing the maximum house price before seeing any property, the prospective homebuyer will then be familiar with the methods the lenders will use to establish whether the buyer can qualify for the mortgage. If you take the time before you begin showing your prospective homebuyer any properties to determine the maximum mortgage the buyer can qualify for, you can avoid many headaches for both you and your buyer. Many times the buyer will tell you the desired price range without really knowing how much home he or she can actually afford. If this is the case and the real estate salesperson takes the prospective buyer at the buyer's word and starts to show homes without first qualifying the buyer, there may be surprises for both you and your buyer. For example, you have as buyers a young couple who say they want an $200,000 house. You take them at face value and begin to show them homes in this price range. After looking at several, they find one that fits their needs and they make an offer. Let us assume the offer is accepted. Later, back at the office, you suggest several lenders to whom they may make application for the mortgage of $160,000. At application, however, they state that they only make $25,000 a year and have several long–term debts. This causes them not to qualify for the mortgage at time of application. This not only will cause you to lose a sale, but will make the mortgage lender less anxious to work with you again. The buyers will lose faith in your ability and turn to another agent. This is not to say that with your qualification of the buyer you will eliminate the possibility of rejection of your buyer by a lender, but it will greatly reduce the number of times your buyers are rejected.

QUALIFYING THE BUYER

Real estate is expensive, almost always requiring a loan for its purchase. Such loans are usually long–term commitments for both buyer and lender. The lender naturally wants to be sure both the property and the borrower make the loan a good risk. Since the savings and loan debacle of the 1980s, lenders have become considerably more diligent in qualifying the buyer and the property.

When a lender qualifies a borrower, it analyzes two general areas:

1. **Income or Ability to Pay** – As a general rule, to qualify for a home loan, lenders prefer that the amount of the borrower's monthly payment for shelter (including homeowners' association dues, insurance, taxes, principal and interest, etc.) not exceed 30% to 35% of borrower's monthly gross income. However, today the ratio of payments to income may often be higher.

2. **Desire or Willingness to Pay** – A person may have the ability to pay but lack the desire or willingness to do so. The desire to pay is just as important, but more difficult to measure. Lenders use a number of methods to determine a person's desire, discussed later in the chapter.

   Each of these two areas will be examined in detail. It should be emphasized that qualifying a borrower is not a strict, precise operation. It is a process in which flexibility and judgment are very important. There are rules that are used to qualify borrowers, but they are merely guidelines and are meant to be flexible. Each borrower is qualified on a case–by–case basis. All aspects of the loan must be weighed before a decision can be made.

There are some additional factors outlined below that lenders look for approving a loan. Each will be discussed in details in this chapter.

- **Stability** – Stability and consistency of the borrower's income sources for the past 2 to 3 years is one of the lender's primary concerns.
- **Secondary Income** – Consistent overtime, bonuses, part time employment, DVA benefits, alimony and child support, etc., are included in gross income. Borrower must be able to verify these sources of income.
- **Debt Payment to Income** – Generally, lenders prefer all monthly payments of debts (longer than 8–10 months), including housing expense, not to exceed 33–36% of borrower's monthly gross income. However, this rule varies from institution to institution.
- **Down payment** – From a lender's viewpoint, the larger the down payment, the less likely the borrower is to default on the payments.
- **Buyer's Credit** – Even though the property value is the lender's main security, emphasis on the borrower's ability to repay a loan is increasing.
- **Title Insurance** – In California, lenders almost always require title insurance on a property, to assure them of protection from any prior encumbrances or rights of others that could adversely affect the position of the lender and/or borrower.

INCOME / ABILITY TO PAY

Whether the borrower earns enough to make the monthly payments is the first consideration in determining the applicant's ***ability*** or ***capacity to repay the loan***. There is no one answer because various lenders use different formulas, depending upon the type of loan. Conventional lenders, FHA, DVA, and Cal–Vet each have their own distinctive method of qualifying a borrower.

TYPES OF INCOME

There is no question that income from regular employment is included, but do lenders count income from overtime, part–time work, or sales commissions? To be counted as stable, income must normally be earned in the same or similar occupation for at least two years. This section covers how lenders look at a variety of income sources.

- **Salaries** – This type of income is the easiest for you to establish and for the lender to verify. A prospective homebuyer who is employed by a company or corporation is usually paid a specific amount on a regular basis. The pay period can be weekly, biweekly, monthly, or bimonthly. This type of income is thought to be the most stable. If the prospective homebuyer is married and the spouse is employed, the income from the spouse will also count if the spouse has met the employment pattern and stability requirements of the lender. In the past, many lenders would discount, or in many cases eliminate, the salaried income of a woman if she was capable of having children, no matter what her profession or how long she had been employed. This practice was stopped with the passage of the Equal Credit Opportunity Act, and lenders are no longer allowed to discount income due to sex, age, or marital status.

- **Overtime** – This type of income is standard to many jobs and can be counted toward the prospective homebuyer's stable monthly in–come. It must be proved by the homebuyer that the income has been regular in the past and that the chances are good that it will continue in the future. To establish that the overtime income has existed in the past, the prospective buyer may wish to supply copies of his or her paycheck stubs to the lender showing the overtime hours worked in the past year. To establish whether the overtime will continue, the mortgage lender will, when verifying the income of the applicant, ask the employer to state if there is a possibility of the overtime continuing.

  Lenders are reluctant to include overtime because, in most cases, it is not consistent and dependable. If borrowers can prove that they will continue to work overtime in the future, lenders will consider overtime pay. In other words, the borrower must have had consistent overtime in the past and must have a job that demands overtime. A good example would be a police officer working as a detective, since such work consistently requires overtime due to the nature of the job. Other examples include firefighters, grocery clerks, truck drivers, and phone company and other utility employees.

- **Commissions** – If the prospective home–buyer is paid by commissions only, or is self–employed, the lenders may require much more information. Usually, the lenders will require either an acceptable profit–and–loss statement and balance sheets for the 2 years preceding, or complete copies of signed federal income tax forms from the previous 2 years. If the homebuyer is self–employed and has recently formed a new company, many lenders will require the in–formation outlined above and current financial statements on the business as well as verification of the employment of the home–buyer for the 2 previous years. A person on straight commission or royalty income for less than 2 years will have a difficult time securing a mortgage, in particular if the prospective buyer is a real estate salesperson on a straight commission basis.

Some commissioned people incur expenses that are not reimbursed by the employer. These expenses must be subtracted from income to arrive at a true income figure. Lenders require income tax returns from commissioned people to verify incomes.

- **Self–Employed** – A self–employed borrower must supply the lender with a balance sheet and profit and loss statements for the business, usually to the end of the most recent quarter. A balance sheet shows the assets, liabilities, and net worth of the business. Profit and loss statements must be provided for the last two years; some lenders require as many as three years of P&L statements. The borrower's income is based on these statements if it appears that the business will continue to produce the same level of income. Profit and loss statements should be carefully analyzed to arrive at a true net income figure. For example, depreciation on real estate is shown as an expense; however, it is not a cash expense, therefore it can usually be added back to net income. By the same token, capital gains taxes must be deducted. In addition, copies of income tax returns filed for at least two years are required.

- **Bonus** – This type of income can also be included in the establishment of the monthly stable income, if the prospective buyer can establish a pattern of payments of the bonus for at least the past two years. This can be done by supplying copies of Internal Revenue Form 1099 if no deductions were withheld from the bonus, or of Internal Revenue Form W–2 if there were deductions made for social security and income taxes. The employer will be asked if there is a possibility that the payment of bonus will continue.

- **Part–Time Work** – At one time, earnings from part–time work were not counted by lenders. For example, if a borrower works only 20 hours a week, the income must be counted if the job is stable.

☞ ***The Federal Equal Credit Opportunity Act specifically prohibits lenders from discounting income solely because it is part time.***

- **Second Job** – Since more and more persons have second jobs, lenders are accepting them more and more as part of the stable monthly income if the prospective home–buyer can establish that the job has existed for at least 2 years and that the possibilities are good for the job to continue. An example of an acceptable buyer with a second job would be a police officer who in his or her off–duty hours has served as a security guard in several banks for the past 3 years. Since this type of second job is in the same field of work and the demand for security in banks is growing, the second job would not only provide extra money, but would be considered by lenders to be stable employment with excellent chances for continuing. Thus, the income would count toward the stable monthly income.

- **Dividend or Interest Income** – This type of income can be counted if it is at least $ 100 per month and the investment that is providing the income is such that it cannot be sold or cashed in easily. This is true if the dividend or interest income is not the primary source of income. If the dividend or interest income is the primary source of the home–buyer's income, the lenders are going to require the homebuyer to show the source of income. If the income is derived from stocks, the lender will request either copies of the stocks or a statement from the brokerage firm that is holding the stock as to the actual ownership of the stock and a summary of the stock performance for the past several years. If the income is from interest, once again the lender will ask the source of income. The lender may ask for copies of the certificates of deposit or a statement from the bank or institution holding the CDs as to ownership and the amount of interest paid. In addition to this information, the homebuyer will be asked to supply complete signed copies of his or her tax returns for the past several years.

- **Tradepeople** – Tradepeople such as carpenters and painters, are treated basically the same as commissioned salespeople. The lender determines the previous two years' income by means of W–2 forms or tax returns. Hourly rates are not used because employment may not have been regular and full time during the year.

- **Rental income** – Rental income can be counted toward the stable monthly income, but many lenders give this type of income special consideration, reviewing it very closely. On many applications, the lenders provide space for rental income to be included, but require the prospective home–buyer to provide the following information:

  1. The gross rental income from the property

  2. The amount of the mortgage payment on the property

3. The amount of the taxes on the property

4. A realistic set of operating expenses for the property

When the information is provided, and prior to the lender approving the net operating income as part of the stable monthly income, some lenders will relate the net operating income to the type of property.

Lenders consider positive cash flow, or spendable income, from real estate as income. Cash flow is gross income less mortgage payments, taxes, and operating expenses. Generally, an investment in a single–family dwelling shows little or negative cash flow. A negative cash flow is regarded as a long–term debt rather than a reduction of income.

When a person wishes to buy and occupy a unit in a two–, three–, or four–unit building, the question that pops up is, Does the income from the other units count? The answer will vary by lender. The typical lender will count the income after subtracting a realistic figure for expenses and vacancy factor. The DVA includes the same income except for one condition: the veteran must have enough cash reserve to be able to absorb from three to six months' payments to cover the likelihood of vacant units. The reason for this is that the DVA has found that most foreclosures on two– to four–unit buildings occur in the first year.

- **Child support or Alimony payments** – This type of income can be included in the determination of the stable monthly income if the applicant or co–applicant *so wishes*. Most lenders will review the payment of such monies in regard to the following items:

  - Are the payments made as a result of a court order?

  - What is the length of time the payments have been made?

  - How regularly have the payments been made? This is accomplished by providing copies of canceled checks or verification of bank deposits.

  - What measures are available to demand payments if payments are missed?

- What are the ages of the children? Are the children all young and are the payments to be made for several years or are the children near the age of consent?

Under the Federal Equal Credit Opportunity Act borrowers need not reveal such income and lenders cannot ask about receipt of income from either child support or alimony. However, a lender can ask about *payment* of child support or alimony for long–term debt purposes.

- **Welfare Income** – This type of income may be counted by the prospective homebuyer if it is to be used as part of the income for repayment of the mortgage. In the past, most lenders discounted or disallowed this type of income as part of the stable monthly income, but this practice was stopped with the passage of the Equal Credit Opportunity Act. These payments, as with any other income, will be verified by the lender as to their amount and frequency.

- **Retirement Income** – Since the age of the borrower can no longer be used as a criterion for the granting of mortgages, more people are buying homes with the intention of retiring and financing the dwelling based on retirement income and personal savings. So income from social security and other pensions or trust funds can be used to establish the stable monthly income.

- **Pensions and Social Security** –Income from pensions and Social Security are counted if such sources are expected to continue on a steady basis. Copies of pension plans are required.

- **Military Personnel** – Military personnel receive extra pay for quarters, clothing, and rations in addition to their base pay. When qualifying someone in the military, all of these extras are added to arrive at the true income. In addition, lenders take into account that military personnel receive free medical and other services.

Stable Monthly Income

After a lender has determined whether a borrower earns enough money, the next step is to analyze the stability of that income.

The stable monthly income can be defined as **“**the borrower's gross monthly income from primary employment base earnings, plus recognizable secondary income.**”** Let us examine the factors that can affect the stable monthly income.

To accomplish this, lenders look at such things as:

1 **Pattern** – First, you must establish the employment pattern of your prospective buyer. Has the person been a job hopper, jumping from one type of work or profession to another for no apparent reason? Lenders look for a pattern of full employment and job changes that improve the applicant's and co–applicant's careers.

2 **Stability** – A second factor that is used to establish the ability of the borrower to repay a mortgage is employment stability–not only the stability of employment in the past, but the potential for future employment. When qualifying your buyer as to the stability of income, you should establish how long the prospective buyer has been employed in his or her present line of work and how long your buyer has been at his or her present job. Most conventional lenders have established a minimum of two years in the buyer's present line of work, with no minimum time on the present job. It should be noted that the important factor is the time in the present line of work.

For example, let us say that a prospective buyer has for the past several years been a lumber salesperson to the construction industry in Northern California and due to the slowdown in construction in that area decided to move to Los Angeles to seek better opportunities. In Los Angeles, the prospective buyer was not able to get a job selling lumber to the construction industry, but was able to get a job selling appliances in a retail store. According to most lenders, the prospective buyer has not changed his or her line of work–sales.

2. **Type of Job** – In addition to the length of employment, the type of job or profession is important. For example, a person who is highly skilled and with good qualifications, such as an MBA graduate from UC–Berkeley will always be in demand and will have little worry in finding employment. Today, with advances in computer technology and the ever–expanding use of computers in industry, a person trained in computer science also will not have a problem finding employment. Other people thought to have stable employment are government employees, engineers, and other skilled people employed by large corporations.

Examples of non–stable jobs include carpenters, painters, roofers, other construction workers and even loan brokers or appraisers. No one working in the construction industry can be sure of the length of his or her job, since it is so transitory.

Self–employed borrowers are another group that are carefully scrutinized to determine their stability of income. Lenders look at the length of time they have been in business, the net income, financial condition of the business, and the general prospects for the particular type of business.

3. **Age of the Borrower** – One other factor that was once thought to affect the stability of income was the age of the applicant. Today, with the passage of federal anti–discrimination legislation, the age of the applicant cannot be used as a factor to establish the stability of the applicant's income. For example, in the past a person who was 45 years old would have had a difficult time securing a 30–year mortgage because many lenders would not make loans to a person where the term of the loan would extend past age 65, then the retirement standard. Thus, the 45–year–old person could only get a 20–year loan no matter what his or her profession.

☞ ***Age is no longer a factor.***

SOURCE OF FUNDS FOR DOWN PAYMENT AND CLOSING COSTS

After the employment pattern and income of the prospective homebuyer is established, the next major item that should be determined is the source of funds for the down payment and closing. This information is necessary not only to establish the maximum house price, but to provide it for the lender who will ask the prospective home–buyer to supply it. There are two basic sources of the funds: from cash on hand (that is, bank accounts) or from the sale of property.

If the source is either a savings or checking account, the lender will verify with the bank or financial institution the date the account was opened and the average balance for at least the past 60 days. If the balance has seen a dramatic increase in the past sixty days, the lender will ask the prospective homeowner to explain the source of the additional funds. For example, say the balance in the account has been approximately $1000, but at the time of the verification the balance is $10,000. The lender will question the source of the additional funds. If the additional funds are a gift from the parents of an applicant, the lender will require a gift letter from the party giving the money. If the additional funds are from a bequest from a will, a copy of the will and a letter from the administrator of the estate may be required.

If the additional cash is due to the sale of property and is so stated at the time of the application or in the initial meeting, the prospective homebuyer will be required to provide the lender with a copy of the earnest money contract if the transaction has not closed. If the transaction is closed, or upon closing, the prospective homebuyer must provide the lender with a copy of the closing statement, 'showing the proceeds to the seller and signed by all parties to the transaction. Some lenders will require a copy of the seller's proceeds check and a copy of the deposit slip.

These are only a few of the types of situations that may arise in determining the amount and source of the down payment and closing costs.

Co–Borrowing

What effect do multiple borrowers–more than one borrower on a loan–have on an application for a real estate loan?

The technical name lenders give a sole borrower is mortgagor. If there is more than one borrower, we have ***co–mortgagors*** (often husband and wife), sometimes called co–borrowers. Co–mortgagors sign the note and deed of trust and go on the title together. It should be noted that ***co–signers*** are not the same as co–mortgagors: Co–signers sign the note as guarantors but are not on the title, do not sign the trust deed, and therefore are rarely acceptable to real estate lenders. Co–mortgagors help with income qualifying but will not help to cure bad credit.

Lenders include all income and all debts from all parties to qualify for the loan. If one or more of the co–mortgagors is not to occupy the home, then things can get complicated. Some lenders insist that all co–mortgagors occupy the home or they will deny the loan. Other lenders will try to work with the parties by counting some of the non–occupying co–mortgagor's income after deducting the co–mortgagor's own housing expenses and other monthly debts. Some lenders require the non–occupying co–mortgagor to be a close relative. Fannie Mae and Freddie Mac, however, have dropped the close relative requirement, but insist that the co–mortgagor not be the seller, builder, real estate broker, or any party who has an interest in the sales transaction. In short, the issue of non–occupying co–mortgagor is fluid and constantly changing, and it is difficult to give any definitive guidelines.

DESIRE TO PAY

It was stated earlier that there are two major considerations in qualifying. One is the *ability* or *capacity of the borrower to pay*, which has been discussed. The other is the ***desire to pay*** (or willingness) of the borrower.

This emotional aspect is closely related to the income of the prospective homebuyer. Many of your prospects may be marginal in their ability to pay by mathematical analysis of their income. These prospective homebuyers, though, may have the desire to pay and are willing to make sacrifices in order to buy the home they want.

How does a lender determine a borrower's *desire?* let's look at some indicators.

- **Payment History** – This desire to pay can be shown by the past payment record of a previous mortgage.

  How a borrower has paid debts in the past is a good indication of what can be expected in the future. If borrowers have paid debts on time in the past, they will likely continue paying on time. On the other hand, if they had problems paying debts in the past, chances are that they will have problems in the future. People develop specific credit patterns. Lenders are interested in the overall pattern and are not concerned about one or two isolated slow payments. Say a borrower has six credit references and five are rated as "paid as agreed" and the other a little slow. Lenders usually ignore the one slow payment because the borrower's overall credit rating is good. The one slow payment is probably an error in rating or may even be a disputed bill. Some buyers are concerned about a problem they may have had with one creditor. They are afraid one bad rating will ruin their chances for a loan. This is not true. Most lenders will accept a valid explanation and be guided by the overall credit history of the borrower.

  On the other hand, a person who has previously owned a home and has adequate income to meet the financial requirements of a mortgage may have a payment record which has not demonstrated the desire to pay, for example, payments may have been regularly late. Thus, in some cases the prospect with the desire to make payments will be given favorable consideration by lenders.

  What if the borrower has had a poor credit history? Does it mean the borrower is automatically eliminated from any type of real estate loan? It is certainly a big strike against the borrower. However, it does not mean the borrower will never obtain a loan. If the borrower is able to explain the reason for the poor credit and convince the lender that he or she is now a good risk, the loan will be seriously considered. People get into financial difficulties for reasons beyond their control. Unemployment, sickness, and divorce are the usual reasons. If a borrower had a credit problem in the past because of unemployment, it does not mean the borrower lacks the desire to pay. It just means there was a temporary problem.

- **Bankruptcies** – People who have had bankruptcies are a special problem. They have had **"**credit failures.**"** It is possible for them to get another loan, but much more difficult, because bankruptcy is usually regarded as an inability to accumulate and manage money.

  In considering those who have had a bankruptcy, lenders want to know the type of bankruptcy. Was it a liquidation (Chapter 7) bankruptcy or a Chapter 13 bankruptcy? Under a Chapter 13, also called the wage–earner's bankruptcy, the individual pays off all creditors in full under a schedule approved by the bankruptcy court. The debtor makes payments to a court–appointed trustee, who, in turn, makes the payments to the creditors over a two– to three–year period. It is obvious that lenders look at someone who opted for a Chapter 13 bankruptcy with more leniency.

  Lenders want a complete explanation as to why the bankruptcy took place. Was it due to circumstances beyond the borrower's control. Or was it due to poor financial management? The answer makes a big difference in the lender's decision. Lenders also insist that time has elapsed since the discharge of the bankruptcy. Most lenders require a two– to three–year waiting period. Under a Chapter 13 bankruptcy, lenders consider the borrower after all creditors have been paid. In some cases, they may even consider the loan if the borrower has completed most of the payments. Another requirement is that borrowers have established good credit since the bankruptcy. Lenders want evidence that the buyer is paying existing debts on a timely basis. Under a Chapter 13 bankruptcy, payments to the trustee would serve as a credit reference.

More on Desire to Pay "Other Motivations and Emotion Needs"

When examining a borrower's desire to pay, we must also consider the borrower's motivation and their emotion needs on the loans. Sometimes a strong desire on the part of the borrower to make the payments is one of the most important reasons for approving a loan. Among the things a lender considers when trying to determine motivation are the following:

- **Desire for homeownership** –During the initial qualification of your buyer, you need to establish the underlying desire for home–ownership. There can be many reasons, including the following:
    - **Nesting**– This is important to young people who either have or are expecting a child.
    - **Investment or Personal Use** – Is the borrower buying the home for *personal* use, or is the purchase an *investment* that is going to be rented? If the purchase is for personal use, the borrower is more likely to keep up the payments. If the purchase is an investment, the borrower may not have the same motivation.
    - **Economic** – To beat inflation or to use the home as a tax shelter.
    - **Retirement** – An older couple who has owned a large home is now looking for housing that meets the needs of an older couple and can serve as a home for their later years.
- **Borrower's Assets** – When analyzing a borrower's capacity to pay, it should be apparent why lenders want to know how much money the borrower earns and the stability of those earnings. What is not so apparent is why lenders analyze borrower assets: because they want to be sure the borrower has enough cash for the down payment and closing costs. If borrowers can't show enough cash, the assumption is that the funds will be sought elsewhere and another debt incurred. This, in turn, can reduce the borrower's ability to make mortgage payments.

  Young couples often receive money for a down payment from their parents. If it is a gift and not a loan, no lender objects to it. However, most lenders insist that the gift be verified, usually in writing. This is called a ***"gift letter."*** Gift giving is restricted in certain programs. For example, under certain loans, including FHA, homebuyers have to document the gift with cancelled check or other evidence showing that the funds came from the parents' account.

The amount and type of assets a borrower has will influence lenders. If the borrower has substantial liquid assets, lenders feel more secure, realizing that, with ample assets, a borrower will continue making the loan payments even if some problems arise. Lenders also give some leeway in qualifying if borrowers have reserves to fall back on. Borrowers with good bank accounts or other assets also demonstrate that they live within their means, are conservative in financial affairs, and have the *ability to accumulate and manage money.*

1. **Down payment** – The amount of down payment heavily influences the borrower's desire to keep up loan payments. If you purchased a house for $100,000 and made a down payment of $50,000, you would do everything possible to maintain the payments. If it became impossible to keep up the payments, you would sell the house. One way or another, you would not let the lender take your house by foreclosure. You would protect your $50,000 investment.

   On the other hand, if you had purchased the same property with little or no down payment, you would not be as motivated to maintain the payments. If you ran into financial problems, it might be easy to talk yourself into letting the lender take back the property. If you have no money invested in the property, you really have nothing to lose except your credit rating. You could easily decide to let the lender foreclose.

   Lenders recognize the importance of the size of the down payment. As the down payment increases, the lender's risk decreases. The size of the down payment is one of the most important factors in determining whether a loan will be approved.

☞ ***No matter what the emotional need of the prospective buyers, many lenders look to see the underlying desire for homeowner–ship.***

LIABILITIES

In addition to the income and emotional reason for buying, the next item that needs to be discussed with prospective home–buyers is their debts and/or obligations. These debts and/or obligations can be divided into two types: long-term and short–term. Most investors are interested in only the long–term debts, for they can have a major effect on a borrower's ability to repay the mortgage. Guidelines used by FHA, Fannie Mae, and Freddie Mac to determine what constitutes a long–term debt will be discussed later.

What are some of the typical debts that prospective homebuyers may have? We will describe some below.

- **Installment debts** – This type of debt can be payments made on a regular basis to department stores for a revolving charge account or a contract on appliances. It can also be payments made on bank credit where there is a continuous balance. Underwriting has become more stringent in this area and credit card payments will be attributed to the borrower even if there is a zero balance. This may be a nominal assessment of $10.00 per month per card, but it represents a potential to expand credit outstanding on the part of the borrower. Most families have a car loan or a bank loan that may be counted as a long–term debt.
- **Loans other than bank loans** – Many people are members of credit unions and have loans from the credit union that are used for many purposes. For example, they may be used to purchase stocks and sometimes to purchase recreational lots or acreage.
- **Comaker or endorser of a note** – In some cases a member of a family will have been a cosigner on a note or loan for one of the older children or a friend. This will have to be shown on the loan application of the homebuyer.
- **Child support or alimony** – This type of court enforced obligation of the prospective homebuyer can be the major payment made apart from the mortgage payment. It should also be pointed out that with the changing divorce laws throughout the United States, in addition to the father being required to make child support payments, some mothers have been ordered to make child support payments to the father if he has been given custody of the children.

These are just a few examples of debts and obligations that may affect the ability of the prospective homebuyer to qualify for a mortgage.

DEBT ANALYSIS

In the past, many real estate professionals have used the formula for the amount of loan a person or family can qualify for as approximately 2.5 times the annual salary. No reference was made to the amount of debts that the person or family had, or how much of the income was used to satisfy those obligations. Today, there are no hard and fast rules used by all conventional lenders to establish ratios of housing cost to income and long–term debts to income. The ratios used by VA and FHA are used by all lenders for underwriting loans either insured by FHA or guaranteed by VA. If your buyer is going to apply for either a loan insured by FHA or guaranteed by VA, you should be able to show your buyer the method for income and debt analysis and be able to determine the approximate loan amount he or she will be able to repay, based on the information he or she supplied.

Income Ratios

Lenders use the monthly payment on a property in determining a borrower's qualifications. The payment includes principal, interest, property taxes, and insurance– commonly referred to as *PITI.* Even if the borrowers are paying their own taxes and insurance, the lender adds them all together in qualifying the borrowers. For FHA, Mutual Mortgage Insurance (MMI) is also included. For condos and PUDs, lenders also include homeowner dues or assessments (PITI).

Lenders use ratios in qualifying a borrower's income. For example, the lender may say the *monthly payment* cannot exceed 25% of the borrower's gross income.

Income ratios used by lenders vary. Today, in many areas of California, borrowers pay about one third or more of their income for housing. The ratios a lender uses are a matter of policy; however, most conventional lenders are strongly influenced by the standards set by Fannie Mae and Freddie Mac. Conventional lenders want to make loans that are saleable in the secondary market. Since these two agencies are the main secondary market sources, many lenders use their income ratio standards.

The current published qualifying income ratio used by the agencies is 28%. Therefore, the borrowers' monthly payments should not exceed 28% of their gross income. Expressing it as a multiplier, we would say the borrower should earn almost four times the monthly payment. Ratios used by the agencies may change at any time because, as the cost of housing increases, borrowers allocate more of their income to housing.

FRONT–END RATIO

The ***qualifying ratio*** is merely a guide, and many loans are approved with higher ratios when "compensating factors" exist, serving as a buffer in case the borrowers face difficulty in meeting payments. Here are some examples of when a lender would feel justified in approving a higher loan ratio:

- Borrowers have a substantial cushion. If the net worth is liquid, it can be used to make the mortgage payments if necessary.
- Borrower has a creditworthy co borrower with additional income.
- Borrowers have excellent potential for higher earnings due to education or training, and current income is stable.
- Borrowers are making a large down payment.
- Borrowers have been making mortgage or rent payments at about the same level as the new loan.

☞ ***Example:***

Borrower Jeffrey's monthly PITI payment is $2300, and his monthly income is $6,500.

Mortgage payment / Gross income = $1,500 / $6,500= 23.07%

*This ratio is frequently referred to as the **top ratio** or **front–end** or **front–door ratio**.*

☞ ***The front–end ration should not exceed 23%.***

The Jeffrey would qualify based on current income guides.

Buy–down loans, graduated–payment mortgages, and adjustable rate loans require special handling. With these loans, the initial payment is lower, and then increases. The problem is, what payment do you use in qualifying the borrower? lenders' choices vary. Some use the initial payment, provided there is a reasonable expectation that the borrower's income will increase to cover the yearly increases in payments. By using the initial payment, borrowers are able to qualify for a larger loan. This is one of the major advantages of buy–downs, graduated–payment mortgages, and adjustable rate loans. However, in some cases, lenders have tightened their standards and qualify borrowers based only on the **"**fully indexed**"** payments, that is, the index plus the margin at time of qualifying.

BACK–END RATIO

So far, we have discussed only a borrower's gross income. Lenders must also take into account the borrower's debts. Lenders break debts down into two categories, short term and long term. The short–term debts are generally ignored, and only long–term debts are considered in qualifying a borrower. How are long–term debts defined?

According to the ratios in effect in 1993, the maximum amount of an applicant's income that could be spent for the payment of long–term debts was 36 percent. According to Fannie Mae/Freddie Mac, a long–term debt is any debt that extends beyond 10 months and must include the amount of the house payment as outlined above. The long–term debt must include any child support or alimony payments.

Conventional lenders follow the standards of Fannie Mae, Freddie Mac, FHA, and PMI companies, which define a long–term debt as a debt that will take *10 months* or longer to pay off. Alimony and child support payments are also considered long–term debts if they will continue for more than 10 months. Other non–housing consumer loans such as auto, furniture, credit card loans are generally counts towards long–term debts.

Once long–term debts have been determined, the lender adds the total to the monthly payment. The two, added together, are called ***"total monthly expenses."*** The total monthly expenses are divided by the borrower's gross income, coming up with another ratio, called the bottom ratio or ***back–end ratio*** or ***back–door ratio****.*

☞ ***The lender use the back–end ratio to see the borrower's financial picture of total obligations.***

☞ ***Conventional lenders again use FNMA and Freddie Mac current standards, which state that this ratio should not exceed 38%, including PMI.***

☞ ***Example:***

Borrower Jeffrey have three loans. He has a car loan of monthly payment of $300 that takes 3 years to pay off, a school loan of monthly payment of $200 that takes 4 years to pay off. Therefore, they are long–term debts. He has a personal loan with a friend with a monthly payment of $50.00 that takes 6 month to pay off.

Therefore, Jeffrey's long–term debts total $500 per month, which, added to the mortgage payment of $1,500, gives us a total monthly expense of $2000.

Total monthly expense / Gross income = $2000 / $6500= 30.77%

On the basis of this back–end ratio, Jeffrey also qualify, since his total monthly expenses is less than 38 percent. Borrowers must qualify on both tests. Some qualify on the first test but not on the second test because they have excessive debts. The second ratio is almost always the more important of the two.

Easy Qualifying – Limited Documents

With 25% or larger down payments many lenders offer **"**limited document**"** or **"**easy qualifying**"** loans, requiring no income or deposit verifications, no IRS W–2s, and no employment verification.

Qualifying under Conventional Guidelines

Many conventional lenders have adopted the income–to–payment and long–term–debt–to–income ratios of Fannie Mae/Freddie Mac for the underwriting of their loans. These guidelines are as follows:

The mortgage loan broker should assume that most lenders will use FNMA or FHLMC guidelines as the industry standard unless given different information when asking about the original setup arrangement. Pre-qualification of the borrower must include not only the principal and interest, but also the taxes and insurance, even though the borrower may choose to make his or her own payments for these items rather than have the lender impound the account. The down–payment requirement for conventional loans usually exceeds the amount required for either FHA or DVA loans. The benefit for conventional financing is that many more lenders are available to fund these loans, and the loan amount is greater; which allows the borrower a wider range of properties to purchase.

The maximum amount a person or family may spend for the monthly payment on housing is **28 percent** of the total gross stable monthly income. The monthly payment will include the following: payments for principal and interest, the amount needed to pay for private mortgage insurance if required, an escrow amount collected monthly to cover the taxes and insurance on the property, and sufficient funds to pay any other fees that may affect title to the property. Such additional fees could be homeowners association fees or special assessments levied by a taxing authority for streets or curbs and gutters.

Many lenders will allow a higher monthly payment ratio if it can be shown that the borrower and the co–borrower can devote more income to the cost of housing or if the property is constructed to be energy efficient. According to Freddie Mac's, *Sellers and Servicers Guide,* Section 2308, higher monthly payment ratios may be appropriate if the following conditions are met:

(i) energy efficient property which reduces energy costs;

(ii) demonstrated ability of Borrower to devote a greater portion of income to basic needs, such as housing:

(iii) demonstrated ability of Borrower to maintain a good credit history, accumulate savings and maintain a debt–free position;

(iv) a larger down payment on the purchase of the property;

(v) Borrower's potential for increased earnings based on education, job training or time employed or practiced in his/her profession: and

(vi) Borrower's net worth being substantial enough to evidence ability to repay the mortgage regardless of income. When the loan–to–value ratio exceeds 80% debt service qualification ratios may be subjected to stricter underwriting standards.

Figure 13-1: Conventional Qualifying Ratios

	Ratios should not exceed:
95% LTV	*26/33*
90% LTV	*28/36*
80% LTV	*32/38*
Adjustable	*26/36*

Figure 13-2: Conventional Loans: Calculating the maximum loan amount from gross income

☞***Example:***

Gross income	3500
Back–end ratio	x 36%
Total available for debt service	$1260
Monthly installment debts	– 200
	$1060
Taxes and insurance/HOA	– 150
Total principal and interest	$910
Payment factor for 8.0% interest rate for 30 years (see figure 13–2)	Divide by / 7.337646
Loan amount	$124,017 (round down to $124,000)

Note: To calculate the sales price the borrow may borrower, divide the loan amount by the LTV.

Maximum purchase price: $124,017 / 0.90 = $137,797.00

Note: Conventional loans quality with a front–end ratio, too. Be sure to take this into account during your final calculations.

☞***Example:***

Total allowable housing expenses	*$910*
Divide by gross income	*Divide by 3500*
Front end ratio	*26%*

This 26% is within the guideline for a FNMA 90% LTV.

QUALIFYING UNDER GOVERNMENT–BACKED LOANS GUIDELINES

FHA QUALIFYING RATIOS AND CALCULATING MAXIMUM LOAN AMOUNT FROM GROSS INCOME

The FHA uses the same qualifying procedure as conventional lenders.

> ☞ ***FHA states that the front–end ratio should not exceed 29%, while the back–end ratio–the more important of the two qualifying tests–should not exceed 41%, including MMI.***

The FHA ratios are higher due to inclusion of MMI in the monthly payments.

The discussion here is limited to the loan broker Federal Housing Administration (FHA) forms needed for calculating the maximum loan amount and the borrower's loan qualification information.

The first step for the mortgage loan broker is to calculate the maximum loan amount from the gross income, with an example shown in Figure 13–3, next page. When the form is followed step by step the result will be the maximum loan amount as set by FHA, which the lender will use as the basic loan guideline. The borrower(s) should furnish the mortgage loan broker with proof of their total verifiable income from all sources and the total monthly expenses that would continue six months after the loan would close. The broker then includes the new loan debt into the formula to derive the maximum monthly payment which is used to calculate the maximum loan amount at the current prevailing interest rate.

The qualifying ratios must also be determined. According to FHA guidelines, the front–end ratio must not exceed a maximum of ***29%,*** unless the borrower has compensating factors. These items might include cash reserves, large equity in other assets, or similar. The total housing payment is divided by the total gross income. The back–end ratio consists of dividing the total housing payment plus any long–term debts and is divided by the total gross income. This cannot exceed ***41%.*** Lenders rarely vary from the FHA ratio guidelines. These items are shown in figure below.

Once the maximum loan amount has been derived, the cash down payment is added to calculate the total maximum sales price. The amount of cash down payment is in excess of the cash needed for any closing costs that must be paid prior to the close of escrow.

Figure 13-1: FHA Loans: Calculating the maximum loan amount from gross income

☞ ***Example:***

Gross income	*3500*
Back–end ratio	*x 41%*
Total available for debt service	*$1435*
Monthly installment debts	*– 200*
	$1235
Taxes and insurance/HOA	*–150*
Total principal and interest	*$1085*
Payment factor for 8.0% interest rate for 30 years (see figure 13–4)	*Divide by / 7.337646*
Loan amount	*$147,867 (round down to $147,850)*

☞ ***Remember:FHA also has a front–end ratio of 29%. After establishing your estimated loan amount, check your front–end ratio for compliance with FHA guidelines.***

☞ ***Example***

Using figures from above:

$1085 Total allowable housing expense
Divide by $3500 Gross income
= 31% Front–end ratio

This 31% exceeds our 29% guideline.

With “compensating factors” this may still be acceptable to FHA.

Figure 13-2: Principal & Interest factors, 15 and 30 years

Interest Rate	15–year P&I factor	30–year P&I factor
4.000	7.396879	4.774153
4.125	7.459676	4.846497
4.250	7.522784	4.919399
4.375	7.586204	4.992853
4.500	7.649933	5.066853
4.625	7.713972	5.141395
4.750	7.778320	5.216474
4.875	7.842974	5.292082
5.000	7.907937	5.368216
5.125	7.973204	5.444870
5.250	8.038777	5.444870
5£75	8.104655	5.599713
5.500	8.170835	5.677890
5.625	8.237317	5.756564
5.750	8.304101	5.835729
5.875	8.371185	5.915378
6.000	8.438568	5.995505
6.125	8.506250	6.076105
6.250	8.574229	6.157172
6.375	8.642504	6.238699
6.500	8.711074	6.320680
6.625	8.779938	6.403110
6.750	8.849095	6.485981
6£75	8.918543	6.569288
7.000	8.988283	6.653025
7.125	9.058312	6.737185
7.250	9.128629	6.821763
7.375	9.199233	6.906751
7.500	9.270124	6.992145
7.625	9.341299	7.077937
7.750	9.412758	7.164122
7.875	9A84499	7.250694
8.000	9.556521	7.337646
8.125	9.628823	7.424972
8.250	9.701404	7.512666
8.375	9.774262	7.600722

8.500	9.847396	7.689135
8.625	9.920804	7.777897
8.750	9.994487	7.867004
8.875	10.068441	7.956449
9.000	10.142666	8.046226
9.125	10.217160	8.136330
9.250	10.291923	8.226754
9.275	10.366952	8.317494
9.500	10.442247	8.408542
9.625	10.517805	8.499894
9.750	10.593627	8.591544
9.875	10.669709	8.683486
10.000	10.746051	8.775716
10.125	10.822652	8.868226
10.250	10.899509	8.961013
10.375	10.976622	9.054070
10.500	11.053989	9.147393
10.625	11.131609	9.240976
10.750	11.209480	9.334814
10.875	11.287600	9.428901
11.000	11.365969	9.523234
11.125	11.444585	9.617806
11.250	11.523446	9.712614
11.375	11.602551	9.807651
11.500	11.681898	9.902914
11.625	11.761486	9.998398
11.750	11.841314	10.094097
11.875	11.921379	10.190008
12.000	12.001681	10.286126
12.125	12.082217	10.382446
12.250	12.162987	10.478964
12.375	12.243989	10.575676
12.500	12.325221	10.672578
12.675	12.406682	10.769664
12.750	12.488370	10.866932
12.875	12.570284	10.964377

DEPARTMENT OF VETERANS AFFAIRS (DVA)

The income ratio is determined by taking the monthly housing expenses–principal, interest, property taxes, insurance, and long–term debts–and dividing this by net take–

home pay. If this ratio is 41% or less, the borrowers qualify. If the ratio is above 41%, then the DVA underwriter must look at other things such as an above–average income under the cash flow approach, a high net worth, or a large down payment.

☞ ***DVA allows back–end ratio 41% ratios because it includes items other than those used by conventional lenders.***

DVA administrators stress that DVA underwriting standards are guidelines and that they are willing to review individual veteran borrowers who do not automatically qualify, similar to the ***compensating factors*** considered by FHA. Examples of compensating factors include larger than normal down payment, insignificant use of credit cards, no vehicle payments, substantial net worth, and stable work experience and history. DVA uses the tightest qualifying standards in lending due to the lack of initial equity.

Cal–Vet

The qualifying procedure used by Cal–Vet is as follows: From gross income, subtract federal and state income taxes and Social Security to arrive at ***adjusted gross income.*** Housing expense is arrived at by adding principal, interest, taxes, property and disability insurance, maintenance, and utilities. Next long–term debts, which are any debts that will take longer than one year to pay off, are totaled and subtracted. The ***remaining income*** is then divided by adjusted gross income to determine the relationship between that and the amount of money left over. This residual should be at least 50% of adjusted gross, though under some circumstances it can be less. This is merely a guide, since Cal–Vet looks closely at the balance of funds left over to determine if they are sufficient to support the family.

FNMA and FHLMC

How do the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) influence the qualification process? First, they affect the purchasing of qualifying loans. While borrowers do not deal directly with either FNMA or FHLMC, these two agencies vitally affect the process of qualifying loan applicants. This is due to the secondary markets in which these agencies operate. As discussed in earlier chapter, conventional lenders sell loans in the secondary market, where Fannie Mae and Freddie Mac are by far the biggest buyers.

Second, they foster uniformity. Loans sold to either FNMA or FHLMC must comply with the qualifying ratios of the purchasing agency. Consequently there is greater standardization and uniformity in qualifying borrowers if lenders expect to sell any of their loans to either of the “big players.” Any conventional loan sold to these agencies, for example, cannot exceed $300,700 for a one–unit dwelling, fixed–rate loan. Hence most lenders will limit their loans secured by houses to $300,700. Of course this figure is subject to periodic changes, usually upward as house prices go up.

CREDIT CHECK

In addition to the verification of the borrowers income, employment, assets, and liabilities, the lenders will be interested in the past credit history of the borrower. As with employment and income the lender will check the credit history of the borrower and/or co–borrower for a minimum of 2 years

As with many other aspects of the real estate transaction, there is a federal law that affects the investigation of a borrowers credit. The law that affects the reporting of credit information is the Fair Credit Reporting Act of 1971. Usually, the credit history of a borrower is reported to the lender or originator by the use of a Standard Factual Data Credit Report.

The act guarantees consumer rights relating to credit information about prospective borrowers' rights to information about their own credit. Three main credit bureaus are used, although several smaller agencies exist. To run a credit report it is necessary to have the written authorization of each person.

The nation's largest credit bureaus operate services that sell credit information to authorized parties. Direct marketers who pitch credit card offers, catalog sales firms, and others may purchase the list of names and addresses of consumers contained in the credit report database of a credit bureau. They do not, however, sell specific credit information–a credit report–without specific authorization from the actual consumer.

To get an actual credit report and meet the guidelines of the laws that pertain to credit, the mortgage broker must have written authorization from the person. One spouse cannot sign to authorize a credit report on the other spouse. A friend or relative cannot authorize credit on a borrower. The only exceptions are the legal documents that the courts have established when one party can act for another, such as a power of attorney or guardianship documents.

The mortgage loan broker must have an original signature in the file that authorizes the broker to run a credit report. The signed credit authorization should specify release of a copy of the authorization to the subsequent, actual lender, who will run the backup credit check. Some credit forms authorize more than just the credit check. They might include authorization for employment verification, bank account verification, and other items that need the signature of the borrower.

Credit report bureaus charge various fees for obtaining a record of their information. The price for one individual or for a couple will vary between agencies. If a joint report is sought, the information needed to run the report must be obtained from both people. Agencies have different types of report information, such as personal credit, business credit, public record, and inquiries from other parties.

The primary credit agencies that perform credit reporting bureau activities are listed below. Should it be necessary to deny credit, consumers are entitled to a free copy of their credit report if they write to the credit reporting bureau within thirty (30) days from the date of the denial.

- Experien (formerly known as TRW)
  P.O. Box 949
  Allen, TX 75013–0949
  (800) 682–7654
- Trans Union Credit Information Co.
  P.O. Box 390
  Springfield, PA 19064
  (800) 851–2674
- Equifax
  P.O. Box 105813
  Atlanta, GA 30348
  (800) 685–1111

It is advisable for consumers to have a credit report run at least once each year to check the records for accuracy. Consumers with extremely common names are advised to run their credit report more often, at least twice a year. With modern technology; consumers can request a credit report by telephone by giving their name and address. They will receive a form by mail to sign, complete, and return. Consumers will receive a copy of their credit report and a detailed explanation of how to read the report information.

To disprove bad credit information, the consumer can write a letter of explanation to keep on file with the credit bureau. The explanation can be up to 50 words and becomes part of the credit report that is printed. Should the report show information that is not the consumer's, the written explanation would so state. The consumer will need to have documentation to explain certain items. Consumers should keep at least 3 years of canceled checks, along with receipts and tax returns, to substantiate their credit.

To run a credit report, the mortgage broker needs to obtain:

1. Original signed credit authorization, separate form
2. Original signature on a loan application form (1003)
3. Credit report fee statement, indicating who pays if a loan closes or is denied

Although the full loan application form has a great deal of data, not all the information is needed to run a credit check. Lenders require the mortgage broker to use at least two of the major credit bureaus as part of the loan package submitted for approval. The following is the minimum information that would be needed to run a credit check:

1. Full name, including first, *middle,* and last, plus **"**nickname**"** and maiden name
2. Date of birth (DOB)
3. Social Security number (SSN)
4. Current address (for the past 2 years)
5. Former address (for the past 5 years)

Mortgage loan brokerage firms often subscribe directly to credit bureau services. The clerical staff of the firm inputs the consumer credit information and the report is sent by electronic means directly to the firm and is printed on their equipment. Anyone who knowingly obtains information from a credit bureau under false pretenses may be fined up to $5000 or imprisoned for up to 1 year or both. The same law applies to unauthorized disclosures made by officers or employees of a credit bureau or of a mortgage loan company.

FICO Credit Scoring

A computerized process credit scoring is an attempt to qualify a potential borrower with a single number. The intent is to aid lenders in determining the likelihood of repayment of a loan.

Scoring has been used in other types of consumer lending for more than 40 years but recently has become widely used by the real estate lending community A repository credit risk score is a specific type of credit score that evaluates the information in a consumer's file at that credit repository.

Fair, Issac & Co. named their credit score after their firm name, and FICO has become the current industry standard. Another firm, Credit Reports, Inc. (CRI) of Tustin, California, began offering scoring in October 1993. Each credit repository has a name for their risk score: TRW uses TRW/FICO Score; Equifax uses Beacon, and Transunion uses Emperica.

A FICO score rates a consumer's creditworthiness based on data in the individual's credit bureau files. A FICO score considers credit card and installment debt experience in giving the rating. One million borrowers nationwide were studied and it was found that borrowers with FICO scores below 600 had a 1 in 9 chance of falling seriously behind or defaulting on a real estate loan. Borrowers with scores above 800 had only a 1 in 1293 chance of having trouble keeping mortgage loan payments current.

Credit bureau scorings evaluate such items as past delinquencies or derogatory payment behavior, current level of indebtedness, length of credit history, type of credit, frequency of application for credit, and credit lines opened. The score reflects the relative risk of serious delinquency, default, foreclosure, or bankruptcy associated with the specific borrower.

The higher the FICO score, the lower the risk of default. FNMA found that less than 10% of their current borrowers had FICO scores below 620. The small group that fell below 620 accounted for half of all defaults.

What constitutes a problem on a credit report? The following are some good rules of thumb that have been adopted by many lenders:

1. No more than one 30– or 60–day late payment for a major installment debt. A major installment debt may be a car payment or any account with a balance in excess of $5,000.

2. No more than two 30– to 60–day late payments on small accounts. This type of account might be a department store charge.

3. No 30– to 60–day late payments showing on a mortgage payment record, unless extreme extenuating circumstances can be proven by the applicant.

4. Many lenders will not approve a mortgage loan for an applicant if the credit report shows any bankruptcies or repossessions within the past 5 years. If either have occurred more than 5 years ago, many lenders will require that the applicant has established a record of god credit.

5. All liens, judgments, and accounts that have gone to collection must have been satisfied or paid in full.

If a person has any of these entries in his or her report, they are said to have derogatory credit information. This does not always mean that the Person may never get credit, but that the applicant may have to provide a satisfactory written explanation stating the reason for the late or missed payments.

When dealing with a lender, it is not uncommon to find that many of the lenders will flat discuss a credit report with an applicant until the applicant has received or has secured a copy of his or her credit report. The reason for this is that many lenders feel that if they discuss the credit prior to the applicant having a copy of the report, they then become a Credit Reporting Agency and must meet the requirements of the Fair Credit Reporting Act as it relates to a credit reporting agency.

Some lenders will even take this a step further and will not in any way discuss a credit report. Normally, if the lender will not discuss the report they will notify the applicant that they have received the report and there is information in the report that needs explaining. They will advise the applicant and/or co–applicant to contact the credit reporting agency for details. A possible reason for some lenders to adopt this policy is that many of the agreements between the credit reporting agencies and their buyers does not allow them to discuss any items on the report, but to refer all questions and explanations to the credit reporting agency. A possible second reason for their reluctance to discuss the report is that Section 610 Conditions of Disclosure to Consumers in paragraph (c) states that “any consumer reporting agency shall provide trained personnel to explain to the consumer any information furnished to him pursuant to Section 609." Since the lenders are not classified as credit reporting agencies and since they do not normally have trained credit reviewing personnel on their staff, they will refer all questions and explanations to the credit reporting agency that provided the report.

Both FNMA and FHLMC now urge lenders to use credit scores in evaluating applicants when the loan is expected to be sold on the secondary money market.

☞ ***FNMA warns lenders that borrowers rated below 620 should not get loans with very low down payments.***

FHLMC is now rejecting 50% more audited loans below the new standards. The new underwriting software systems are automatically producing FICO scores along with LTV and debt–to–equity ratios. In addition, the credit rating score is nondiscriminatory because it does not consider gender or ethnicity and uses only the FICO score as a rating stick.

One question that may be asked by a buyer about his or her credit is, How long does a bad entry stay on my credit report?

According to the Fair Credit Reporting Act, Section 605, entitled ***Obsolete Information***, certain information may not be included on a credit report for a loan with a principal balance of $50,000 or less. According to this section, the time limits are as follows:

1. Cases under Title 11 of the U.S. Code or Bankruptcy Act that occur more than 10 years prior to the date of the credit report may not be included.
2. Suits and judgments may not be included in the report where the date of entry is more than 7 years or sooner if the governing statutes of limitations has expired.
3. Paid tax liens where the date of payment is 7 years or more prior to the date of the credit report may not be included.
4. Accounts placed for collection or charged to profit and loss more than 7 years prior to the date of the credit report may not be included.

5. Any record of arrest, indictments, or convictions for a crime which from the date of disposition, release, or parole, happened more than 7 years before the date of the requested credit report may not be included.

6. Or any other adverse action that has happened more than 7 years ago may not be included.

As was mentioned in the first part of this discussion, three restrictions only apply to loans with a principal balance of less than $50,000. Many of the credit reporting agencies follow the above guidelines for all loans whether they are more or less than $50,000.

In some cases, a local credit bureau will not report any information about arrest, indictment, or conviction for a crime.

From this brief discussion one can see that the credit history could be an area that may delay the process of a loan application, particularly if the lender does not discuss any information on a credit report. A possible solution to the problem is to have your buyer, prior to completing a loan application, go to the credit reporting agency in your city and request to check the credit information that is on file. The consumer has a right to view the information with certain exceptions as per Section 609, Disclosure to Consumers, of the Act. It should be noted that the consumer will not normally be given a copy of his or her credit report, but will be supplied with an abstract.

The abstract will have stamped or noted on it in some manner the following statement: Not For Credit Granting Purposes. In this way the person, before going to loan application, can find if there is any derogatory information or credit information that is not theirs on the report and correct or give an explanation before the lender requests a credit report. Also, they could take the abstract to loan application and when the person taking the application asks about credit, the applicant could give the lender a copy of the abstract. It should be noted that the lender will still order a credit report, but possibly if the lender questions any entry on the abstract, the lender could ask for clarification at the time of application rather than waiting to receive the credit report and having the buyer make explanations at the credit reporting agency.

One final item regarding the credit history of a buyer: if you are working with a buyer who is moving from another city, you may suggest to that person that they should have their credit transferred from the city they are leaving. There are two good reasons:

1. If the credit is not transferred, it is classified as an out–of–town credit report and normally the credit reporting agencies charge more for such a report.

2. Since the report has to come from outside or from another city, the time to get a report is usually longer, and could possibly slow down loan approval.

CHAPTER QUIZ

1. The best way to shop for a loan is to:

   A. Make trial applications to several lenders
   B. Ask detailed questions of the lenders
   C. Read the lenders' advertisements carefully
   D. These is no need to shop, since government regulations effectively make all lenders' terms the same

2. Income is considered stable by most lenders if

   A. it has been earned regularly for two years.
   B. the applicant has been in the same line of work for several years, even if he or she has been on a new job for one month.
   C. the type of occupation would normally warrant it.
   D. all of the above apply.

3. Lenders would feel justified in approving a higher loan ratio when there are compensating factors present, such as

   A. exceptional education and training.
   B. Large down payment.
   C. substantial net worth.
   D. any of the above.

4. The ability or capacity to pay is best defined as the

   A. applicant's total assets.

B. borrower's willingness to repay loans.
C. ability to repay debts.
D. current mortgage activity.

5. The process by which a borrower can find out in advance what financing will he available to him or her is called:

A. Shopping the loan
B. Pre-qualifying
C. Truth in lending disclosure
D. A conforming loan

6. Qualifying standards for borrowers using conventional loans that are to be sold to Fannie Mae/Freddie Mac

A. Differ widely, depending upon the particular lender.
B. Are usually the same throughout the range of lenders.
C. Are set by various government bodies.
D. Differ greatly, depending upon whether the lender is state or federally chartered.

7. Qualifying for a conventional loan normally does not permit:

A. Gift money for the down payment
B. A previous bankruptcy
C. A 100% loan (no down payment)
D. All of the above

8. Maximum allowable ratios of housing expense to income can vary with the:

A. Loan to value ratio
B. Lender
C. Size of down payment
D All of the above

9. Each of the following is considered income ***except:***

A. continuing spousal support.
B. gifts from family members.
C. positive cash flows from rentals.
D. self–employment income.

10. In a DVA loan, the maximum loan amount is established by

    A. The U.S. Dept. of Veterans Affairs
    B. FNMA and GNMA ceilings
    C. The lender's policy
    D. Both B and C

Answer Key: 1–B, 2–D, 3–D, 4–C, 5–B, 6–B, 7–D, 8–D, 9–B, 10–A

CHAPTER 14: THE LOAN PROCESSING

PREVIEW

This chapter describes how lenders process real estate loans. The discussion covers a loan application and a loan package, approval, the process of closing a loan and the documents that are used, closing costs, loan payments, late charges, prepayment privileges and penalties, and loan assumptions. The chapter also details the basic provisions of laws that affect the processing and closing of loans.

LOAN APPLICATION

All loan processing and underwriting begins with an application. The application may be in several forms, but we will review only those forms used by the FNMA/FHLMC, FHA and VA standard application form shown as Form 14–1.

The loan application is not an appropriate tool for shopping for a loan. It is for the purpose of applying to a specific lender, for a specific loan, under specific terms, on a specific property, by a prospective borrower who presumably will follow through and borrow if the loan is approved.

After receiving the application, the lender makes a preliminary analysis of the borrower's qualifications. If it appears that the applicant is qualified, the lender orders an appraisal of the property. Though procedures differ, many lenders begin processing applications while awaiting the appraisal report.

If the borrower is not qualified based on a preliminary look at the application, many lenders may not order the approval.

Lenders expect repayment of loans without experiencing collection, servicing, or foreclosure difficulties. Lenders are understandably concerned that they make loans to individuals who will repay loans in a timely manner. Therefore, employment stability, income probability, history of debt management and net worth are important considerations for the lender in evaluating a borrower's strength and ability to meet financial obligations.

Even though applications may vary in format and length, they generally ask the same basic questions. The basic items in loan applications include:

1. employment,
2. income,
3. assets,
4. debts, and
5. credit history.

☞ ***Many lenders use the FNMA 1003 form even if the loans are not intended to be sold in the secondary market.***

Borrower's Information

Helps a lender evaluate a borrower's ability and willingness to repay the loan.

- **Employment** – Gross salary, type of employment, and length of time employed are considerations. Two years full time employment in the same field is generally desirable. However, a college degree with a major in the field of employment will often be accepted in lieu of the two years employment Self–employed borrowers are usually required to provide two to three years' financial statements as well as income tax returns for lender review.

- **Other Income** – Many families today rely heavily on secondary income (part–time employment, bonuses, overtime). If this income is typical for the occupation and stable, the lender will probably look favorably upon it in evaluating the borrower's earning capacity, as many components make up income probability. If a borrower is self–employed, profit and loss statements, balance sheets and copy of borrower's signed federal income tax returns for the two years immediately prior to the borrower's loan application are usually requested as verification of income.

- **Dependents** – Number of dependents being supported by the borrower, and for how long, is a consideration.
- **Living Expenses** – The lender considers the amount of the applicant's income remaining to pay on the loan, taxes, and insurance, after deducting living expenses. Current mortgage payments or current rent payments are relevant.
- **Relationship with the Lender** – If a borrower has a previous or existing relationship with the lender, the lender may evaluate that relationship when considering the borrower's latest application, subject to certain non–discrimination laws.
- **References and Credit Reports** – The lender will check credit and personal references of the borrower. Telephone checks and the use of credit reporting agencies are common. The borrower should bring any delinquencies to the attention of the lender, and the reason they occurred, rather than letting the lender discover them later.
- **Property Information** – The property financed is the collateral for the loan. Information is required by the lender to determine its value as security. (See previous chapter, "Qualifying the Property.")
- **Identification** – Specific location of the property, normally the legal description.
- **Preliminary Title Information** – Any claims, encumbrances, liens, etc.
- **Improvements** – Description of land and improvements, including any work done in the past 90 days that might be subject to a mechanics lien.
- **Economic Data** – Taxes, zoning, assessments, price and terms, date of construction, and income data if an income property.
- **Rental Statement** (for Income Property) – The repayment ability of the property; the property's capacity to generate enough income toward repaying the loan.

- **All Pertinent Data** – The loan application, then, is designed to show all pertinent data about a borrower needed by a lender in considering a loan. Perhaps the one most important item the loan officer seeks in the application and loan interview is evidence of borrower stability; stability in money management, debt payments, and employment is vital.

- **Prohibited Discrimination** – It is clear from the previous paragraph that a lender must be very discriminating in approving a loan for a certain borrower. *Financial ability* and *reliability* must be carefully evaluated. However, the Federal Equal Credit Opportunity Act (ECOA) prohibits discrimination based on age, sex, race, marital status, color, religion, or national origin. Senior citizens, young adults, and single persons must be considered in light of income adequacy, satisfactory net worth, job stability and satisfactory credit rating. Credit guidelines must be applied to each prospective borrower in the same manner.

☞ ***The more thorough the information provided by the borrower (e.g., addresses, telephone numbers, etc.) the faster and easier it is for the loan officer to verify and evaluate the loan application.***

TAKING THE LOAN APPLICATION

The lender evaluates the initial information obtained on the borrower and the property.

- **Borrower Interview** – Many lenders regard a personal interview as highly desirable. Reasons for this include *verification* and *clarification.*

  - **Application Accuracy** – The loan officer has the opportunity to verify the accuracy of the information with the applicant and to make a personal judgment of the borrower's character. The loan officer may complete the loan application during the personal interview.

  - **Ability to Repay** – The loan officer can verify this with the borrower. For example, is the borrower's income adequate to make payments? The loan officer may collect such things as IRS W–2 forms for the past two years, IRS 1040s, or recent pay check stubs, and may verify current status of outstanding financial obligations.

- **Loan Costs** – All costs involved should be discussed and understood by the borrower.

- **Appraisal Report** – This can be made by an employee of the lender or by an outside appraiser. The current value of the property and the value trend are needed.

COMPLETING THE FNMA UNIFORM RESIDENTIAL LOAN APPLICATION

The first section of the application has to do with the type of mortgage being applied for: conventional, VA, or FHA. The interest rate and the term of the mortgage as well as the monthly payments are calculated, and finally the escrow or impounds are indicated.

In the next section of the application, Subject Property, the property is identified by both a street address and a legal description. Next, the lender will need to know the purpose of the loan, whether it is to purchase, to construct, or to refinance existing financing. If the purpose is either to construct or to refinance, additional information is requested. The final portion of this section asks in whose names the title to the property will be held and in what manner the title will be held: community property, tenancy–in–common, joint tenancy, and so forth.

Therefore, you will need to tell the prospective homebuyer how the title can be held and help him or her arrive at a decision, or advise them of the lender's requirements as to how the title will be held.

The next sections have to do with the borrower and co–borrower. Normally, a lender will not allow the borrower to give the information for the co–borrower or vice versa. Both parties, therefore, must be present at the time of application. What information is required seems self–explanatory, but there are some important items that should be reviewed. The first is the applicant's present address. If either the borrower or co–borrower has resided at his or her present address for less than 2 years, the lender will request the prior address to establish residency for the past 2 years. If the borrower or co–borrower has rented, the lender will need the name and address of the landlord or rental agent to verify the residency and payment record of the borrower or co–borrower. If the borrower or co–borrower has owned or was purchasing a home and was making mortgage payments, he or she will have to supply the name and address of the mortgage lender as well as his or her account number for the lender to verify the mortgage and payment record of the borrower and/or co–borrower. The borrower and/or the co–borrower will also need to furnish the names and addresses of employers for the past 2 years. These addresses should be accurate, for the lender will wish to verify the employment. If the address is incorrect, it can slow the processing of the application.

The next section of the application is divided into three sections: Gross Monthly Income, Monthly Housing Expenses, and Details of the Purchase. This section is self–explanatory and the information required is not difficult to furnish.

In the next section of the application, the borrower or co–borrower describes other income, if any. Once again, sufficient information must be supplied to allow the lender to verify the income.

In the section entitled **"**If Employed in the Current Position For Less Than Two Years,**"** the borrower and co–borrower are given additional room to establish a 2–year work record; the information must be sufficient to allow the lender to verify the employment.

The final section of the first page is composed of several questions. If any question is answered **"**yes**"** by either the borrower or co–borrower, the answer must be explained in depth.

The second page of the application is devoted primarily to the financial and credit history of the borrower and co–borrower. The first section is divided into two parts, the first being the assets and the second being the liabilities of the borrower or co–borrower. The information requested needs no in–depth explanation here. It should be noted, however, that complete information about any installment debts is once again required; the lender verifying the credit of the borrower or co–borrower will need this information for the credit–checking agency.

At the end of the liability and assets section there is a place for the borrower and co–borrower to list all of the real estate they own. You will note that, after the address of the property, the borrower or co–borrower must state whether the property is sold, whether a sale is pending, or whether the property is being held for rental purposes. If the property is sold, the lender will require a copy of a closing statement. It the sale is pending, the lender may request a copy of the earnest money contract and will not close the loan until a copy of the closing statement is furnished, if the sale proceeds are to be used as part of the down payment or for closing costs.

The next major section of the application is for previous credit references. Here the borrower will list any loans or charge accounts that have been paid in full to any credit–granting organization.

Immediately below the previous credit section is an agreement the borrower and co–borrower must sign. The borrower and co–borrower at this time must declare their intent either to occupy or not to occupy the property. By signing the statement, the borrower and co–borrower acknowledge that they can be punished by the federal government if they knowingly make any false statement.

Some of the information needed to determine if a lender is discriminating due to color, race, or sex is contained in the section entitled Information for Government Monitoring Purposes. Because this information is not used in the processing or approval of a loan, the borrower and co–borrower are not required to furnish the requested information.

Form 14-1: FNMA Uniform Residential Loan Application (4 pages)

Uniform Residential Loan Application

This application is designed to be completed by the applicant(s) with the lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower", as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when ☐ the income or assets of a person other than the "Borrower" (including the Borrower's spouse) will be used as a basis for loan qualification or ☐ the income or assets of the Borrower's spouse will not be used as a basis for loan qualification, but his or her liabilities must be considered because the Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

Mortgage Applied for: ☐ VA ☐ FHA ☐ Conventional ☐ FmHA ☐ Other: | Agency Case Number | Lender Case No.

Amount $ | Interest Rate % | No. of Months | Amortization Type: ☐ Fixed Rate ☐ GPM ☐ Other (explain): ☐ ARM (type):

Subject Property Address (street, city, state, & ZIP) | No. of Units

Legal Description of Subject Property (attach description if necessary) | Year Built

Purpose of Loan ☐ Purchase ☐ Refinance ☐ Construction ☐ Construction-Permanent ☐ Other (explain): | Property will be: ☐ Primary Residence ☐ Secondary Residence ☐ Investment

Complete this line if construction or construction-permanent loan.

Year Lot Acquired	Original Cost	Amount Existing Liens	(a) Present Value of Lot	(b) Cost of Improvements	Total (a + b)
	$	$	$	$	$

Complete this line if this is a refinance loan.

Year Acquired	Original Cost	Amount Existing Liens	Purpose of Refinance	Describe Improvements ☐ made ☐ to be made
	$	$		Cost: $

Title will be held in what Name(s) | Manner in which Title will be held | Estate will be held in: ☐ Fee Simple ☐ Leasehold (show expiration date)

Source of Down Payment, Settlement Charges and/or Subordinate Financing (explain)

Borrower | **Co-Borrower**

Borrower's Name (include Jr. or Sr. if applicable) | Co-Borrower's Name (include Jr. or Sr. if applicable)

Social Security Number | Home Phone (incl. area code) | Age | Yrs. School | Social Security Number | Home Phone (incl. area code) | Age | Yrs. School

☐ Married ☐ Separated ☐ Unmarried (include single, divorced, widowed) | Dependents (not listed by Co-Borrower) no. ages | ☐ Married ☐ Separated ☐ Unmarried (include single, divorced, widowed) | Dependents (not listed by Borrower) no. ages

Present Address (street, city, state, ZIP) ☐ Own ☐ Rent ______ No. Yrs. | Present Address (street, city, state, ZIP) ☐ Own ☐ Rent ______ No. Yrs.

If residing at present address for less than two years, complete the following:

Former Address (street, city, state, ZIP) ☐ Own ☐ Rent ______ No. Yrs. | Former Address (street, city, state, ZIP) ☐ Own ☐ Rent ______ No. Yrs.

Former Address (street, city, state, ZIP) ☐ Own ☐ Rent ______ No. Yrs. | Former Address (street, city, state, ZIP) ☐ Own ☐ Rent ______ No. Yrs.

Name & Address of Employer ☐ Self Employed | Yrs. on this job | Yrs. employed in this line of work/profession | Name & Address of Employer ☐ Self Employed | Yrs. on this job | Yrs. employed in this line of work/profession

Position/Title/Type of Business | Business Phone (incl. area code) | Position/Title/Type of Business | Business Phone (incl. area code)

If employed in current position for less than two years or if currently employed in more than one position, complete the following:

Name & Address of Employer ☐ Self Employed | Dates (from - to) | Monthly Income $ | Name & Address of Employer ☐ Self Employed | Dates (from - to) | Monthly Income $

Position/Title/Type of Business | Business Phone (incl. area code) | Position/Title/Type of Business | Business Phone (incl. area code)

Name & Address of Employer ☐ Self Employed | Dates (from - to) | Monthly Income $ | Name & Address of Employer ☐ Self Employed | Dates (from - to) | Monthly Income $

Position/Title/Type of Business | Business Phone (incl. area code) | Position/Title/Type of Business | Business Phone (incl. area code)

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Gross Monthly Income	Borrower	Co-Borrower	Total	Combined Monthly Housing Expense	Present	Proposed
Base Empl. Income *	$	$	$	Rent	$	
Overtime				First Mortgage (P&I)		$
Bonuses				Other Financing (P&I)		
Commissions				Hazard Insurance		
Dividends/Interest				Real Estate Taxes		
Net Rental Income				Mortgage Insurance		
Other (before completing, see the notice in "describe other income," below)				Homeowner Assn. Dues		
				Other:		
Total	$	$	$	Total	$	$

* Self Employed Borrower(s) may be required to provide additional documentation such as tax returns and financial statements.

Describe Other Income *Notice:* Alimony, child support, or separate maintenance income need not be revealed if the Borrower (B) or Co-Borrower (C) does not choose to have it considered for repaying this loan.

B/C		Monthly Amount
		$

ASSETS AND LIABILITIES

This Statement and any applicable supporting schedules may be completed jointly by both married and unmarried Co-Borrowers if their assets and liabilities are sufficiently joined so that the Statement can be meaningfully and fairly presented on a combined basis; otherwise separate Statements and Schedules are required. If the Co-Borrower section was completed about a spouse, this Statement and supporting schedules must be completed about that spouse also.

Completed ☐ Jointly ☐ Not Jointly

ASSETS Description	Cash or Market Value
Cash deposit toward purchase held by:	$
List checking and savings accounts below	
Name and address of Bank, S&L, or Credit Union	
Acct. no.	$
Name and address of Bank, S&L, or Credit Union	
Acct. no.	$
Name and address of Bank, S&L, or Credit Union	
Acct. no.	$
Name and address of Bank, S&L, or Credit Union	
Acct. no.	$
Stocks & Bonds (Company name/number & description)	$
Life insurance net cash value	$
Face amount: $	
Subtotal Liquid Assets	$
Real estate owned (enter market value from schedule of real estate owned)	$
Vested interest in retirement fund	$
Net worth of business(es) owned (attach financial statement)	$
Automobiles owned (make and year)	$
Other Assets (itemize)	$
Total Assets a.	$

Liabilities and Pledged Assets. List the creditor's name, address and account number for all outstanding debts, including automobile loans, revolving charge accounts, real estate loans, alimony, child support, stock pledges, etc. Use continuation sheet, if necessary. Indicate by (*) those liabilities which will be satisfied upon sale of real estate owned or upon refinancing of the subject property.

LIABILITIES	Monthly Payt. & Mos. Left to Pay	Unpaid Balance
Name and address of Company Acct. no.	$ Payt./Mos.	$
Name and address of Company Acct. no.	$ Payt./Mos.	$
Name and address of Company Acct. no.	$ Payt./Mos.	$
Name and address of Company Acct. no.	$ Payt./Mos.	$
Name and address of Company Acct. no.	$ Payt./Mos.	$
Name and address of Company Acct. no.	$ Payt./Mos.	$
Name and address of Company Acct. no.	$ Payt./Mos.	$
Alimony/Child Support/Separate Maintenance Payments Owed to:	$	
Job Related Expense (child care, union dues, etc.)	$	
Total Monthly Payments	$	
$	**Total Liabilities b.**	$

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Schedule of Real Estate Owned (If additional properties are owned, use continuation sheet.)

Property Address (enter S if sold, PS if pending sale or R if rental being held for income)	Type of Property	Present Market Value	Amount of Mortgages & Liens	Gross Rental Income	Mortgage Payments	Insurance, Maintenance, Taxes & Misc.	Net Rental Income
		$	$	$	$	$	$
	Totals	$	$	$	$	$	$

List any additional names under which credit has previously been received and indicate appropriate creditor name(s) and account number(s):

Alternate Name	Creditor Name	Account Number

VII. DETAILS OF TRANSACTION

a. Purchase price	$
b. Alterations, improvements, repairs	
c. Land (if acquired separately)	
d. Refinance (incl. debts to be paid off)	
e. Estimated prepaid items	
f. Estimated closing costs	
g. PMI, MIP, Funding Fee	
h. Discount (if Borrower will pay)	
i. Total costs (add items a through h)	
j. Subordinate financing	
k. Borrower's closing costs paid by Seller	
l. Other Credits (explain)	
m. Loan amount (exclude PMI, MIP, Funding Fee financed)	
n. PMI, MIP, Funding Fee financed	
o. Loan amount (add m & n)	
p. Cash from/to Borrower (subtract j, k, l & o from i)	

VIII. DECLARATIONS

If you answer "yes" to any questions a through l, please use continuation sheet for explanation.

	Borrower Yes	Borrower No	Co-Borrower Yes	Co-Borrower No
a. Are there any outstanding judgments against you?	☐	☐	☐	☐
b. Have you been declared bankrupt within the past 7 years?	☐	☐	☐	☐
c. Have you had property foreclosed upon or given title or deed in lieu thereof in the last 7 years?	☐	☐	☐	☐
d. Are you a party to a lawsuit?	☐	☐	☐	☐
e. Have you directly or indirectly been obligated on any loan which resulted in foreclosure, transfer of title in lieu of foreclosure, or judgment? (This would include such loans as home mortgage loans, SBA loans, home improvement loans, educational loans, manufactured (mobile) home loans, any mortgage, financial obligation, bond, or loan guarantee. If "Yes," provide details, including date, name and address of Lender, FHA or VA case number, if any, and reasons for the action.)	☐	☐	☐	☐
f. Are you presently delinquent or in default on any Federal debt or any other loan, mortgage, financial obligation, bond, or loan guarantee? If "Yes," give details as described in the preceding question.	☐	☐	☐	☐
g. Are you obligated to pay alimony, child support, or separate maintenance?	☐	☐	☐	☐
h. Is any part of the down payment borrowed?	☐	☐	☐	☐
i. Are you a co-maker or endorser on a note?	☐	☐	☐	☐
j. Are you a U.S. citizen?	☐	☐	☐	☐
k. Are you a permanent resident alien?	☐	☐	☐	☐
l. Do you intend to occupy the property as your primary residence? If "Yes," complete question m below.	☐	☐	☐	☐
m. Have you had an ownership interest in a property in the last three years?	☐	☐	☐	☐
(1) What type of property did you own–principal residence (PR), second home (SH), or investment property (IP)?				
(2) How did you hold title to the home–solely by yourself (S), jointly with your spouse (SP), or jointly with another person (O)?				

IX. ACKNOWLEDGMENT AND AGREEMENT

The undersigned specifically acknowledge(s) and agree(s) that: (1) the loan requested by this application will be secured by a first mortgage or deed of trust on the property described herein; (2) the property will not be used for any illegal or prohibited purpose or use; (3) all statements made in this application are made for the purpose of obtaining the loan indicated herein; (4) occupation of the property will be as indicated above; (5) verification or reverification of any information contained in the application may be made at any time by the Lender, its agents, successors and assigns, either directly or through a credit reporting agency, from any source named in this application, and the original copy of this application will be retained by the Lender, even if the loan is not approved; (6) the Lender, its agents, successors and assigns will rely on the information contained in the application and I/we have a continuing obligation to amend and/or supplement the information provided in this application if any of the material facts which I/we have represented herein should change prior to closing; (7) in the event my/our payments on the loan indicated in this application become delinquent, the Lender, its agents, successors and assigns, may, in addition to all their other rights and remedies, report my/our name(s) and account information to a credit reporting agency; (8) ownership of the loan may be transferred to successor or assign of the Lender without notice to me and/or the administration of the loan account may be transferred to an agent, successor or assign of the Lender with prior notice to me; (9) the Lender, its agents, successors and assigns make no representations or warranties, express or implied, to the Borrower(s) regarding the property, the condition of the property, or the value of the property.

Certification: I/We certify that the information provided in this application is true and correct as of the date set forth opposite my/our signature(s) on this application and acknowledge my/our understanding that any intentional or negligent misrepresentation(s) of the information contained in this application may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq. and liability for monetary damages to the Lender, its agents, successors and assigns, insurers and any other person who may suffer any loss due to reliance upon any misrepresentation which I/we have made on this application.

Borrower's Signature	Date	Co-Borrower's Signature	Date
X		X	

X. INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the Federal Government for certain types of loans related to a dwelling, in order to monitor the Lender's compliance with equal credit opportunity, fair housing and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a Lender may neither discriminate on the basis of this information, nor on whether you choose to furnish it. However, if you choose not to furnish it, under Federal regulations this Lender is required to note race and sex on the basis of visual observation or surname. If you do not wish to furnish the above information, please check the box below. (Lender must review the above material to assure that the disclosures satisfy all requirements to which the Lender is subject under applicable state law for the particular type of loan applied for.)

BORROWER

☐ I do not wish to furnish this information

Race/National Origin: ☐ American Indian or Alaskan Native ☐ Asian or Pacific Islander ☐ White, not of Hispanic Origin ☐ Black, not of Hispanic origin ☐ Hispanic ☐ Other (specify) ____________

Sex: ☐ Female ☐ Male

CO-BORROWER

☐ I do not wish to furnish this information

Race/National Origin: ☐ American Indian or Alaskan Native ☐ Asian or Pacific Islander ☐ White, not of Hispanic Origin ☐ Black, not of Hispanic origin ☐ Hispanic ☐ Other (specify) ____________

Sex: ☐ Female ☐ Male

To be Completed by Interviewer	Interviewer's Name (print or type)	Name and Address of Interviewer's Employer
This application was taken by:	Interviewer's Signature — Date	
☐ face-to-face interview ☐ by mail ☐ by telephone	Interviewer's Phone Number (incl. area code)	

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Continuation Sheet Residential Loan Application

Use this continuation sheet if you need more space to complete the Residential Loan Application. Mark B for Borrower or C for Co-Borrower.	Borrower:	Agency Case Number:
	Co-Borrower:	Lender Case Number:

I/We fully understand that it is a Federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

Borrower's Signature:	Date	Co-Borrower's Signature:	Date
X		X	

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Information For Loan Application

Now that we have briefly reviewed the loan application, you now have a better understanding of the information that will be required by the lender at the time of the face–to–face interview to gather the data for the loan application. Often a lender will use a copy of the Residential Loan Application even though the applicant will be making application for a FHA–insured or VA–guaranteed loan. As a real estate professional you should counsel your prospective homebuyer concerning the required information they should bring with them when they make application. It should be noted that you should, if possible, always go with your buyers to the application appointment. This is important, for no matter how many times a person has gone through the loan application process, it is still a frightening experience. You will be a familiar face and comfort to them. The following list of information needed at the time of loan application is only a partial list and as you become more experienced you will be able to develop your own checklist of items or information necessary for the application appointment.

1. A legible copy of the earnest money contract for the transaction. It must contain the original signatures of the parties to the transaction. The buyers' names on the contract should read in the same manner as they will hold title to the property they are purchasing.

2. If the applicant and/or co–applicant have resided at their address for less than 2 years, they must provide sufficient addresses for the lender to verify residence for a period of 2 years.

3. If they own their current home and it is mortgaged, they will need to provide the name, address, and zip code of the mortgage company. In addition, they should provide the loan number as well as supply the type (conventional FHA, or VA).

4. If they are renting, they will need to supply the name and address of their landlord.

5. Copies of their last years W–2s as well as their most current paycheck stub.

6. Social Security numbers are required on any FHA–insured, VA–guaranteed, or a loan to be sold to Fannie Mae. Freddie Mac does not currently require this information.

7. Name and address of all financial institutions as well as all account numbers for all checking, savings, credit union, certificate of deposit, money market accounts, and so forth.

8. If a borrower and/or co–borrower are divorced, they will need to provide a copy of the decree.

9. If the borrower and/or co–borrower will use assets to close, they will need to furnish copies of the stock certificates, bonds, certificates of deposits, and so forth.

10. A list of current obligations, including current balances, account numbers, monthly payment; name, address and zip code of lender or store. Also the account number of all credit bank type cards even though there is no balance.

11. If the applicant is self–employed, provide signed and dated, last 2 years of individual tax returns with all schedules. Also a year–to–date profit and loss statement; if possible, prepared and signed by a CPA as well as the borrower. If the borrower owns 25 percent or more of a business, 2 years of tax returns on the business with all schedules.

12. If the borrower and/or co–borrower will be using income from rental properties, they will need to provide a copy of their federal income tax return, Schedule E, Supplemental Income Schedule, as evidence of rental income. Many lenders will not count the rent from any property not listed on Schedule E as income unless the borrower provides a copy of a lease. In addition they must supply the address of the property, name and address of the lender, loan number, approximate loan balance, amount of the total monthly payment, gross rental income, and the resale value of the property. This information will be used to complete a Schedule of Real Estate Owned.

13. Verification of retirement income–a photocopy of the award letter (with Copies of canceled check attached), tax returns, or IRS W–2 forms.

14. Verification of Social Security income–a copy of the Social Security Administration's award letter or a copy of the borrower's last 12 bank statements to confirm the regular deposit of the payment.

15. Verification of VA benefits. Most VA benefits are acceptable to most lenders if they are documented by a letter or distribution forms from the DVA and will continue for at least 3 years.

16. Verification of income from notes receivable – a copy of the note to establish the amount and length of payments. Payments must continue for at least 3 years after the date of the mortgage application and must have been received for the last 12 months.

17. If any of the funds used for a portion of the down payment or closing cost and prepaids is a gift, the borrower and/or co–borrower must provide a copy of a gift letter. This letter must be from a family member or an unrelated person who has demonstrated an established personal relationship to the borrower and/or co–borrower who does not relate to the mortgage loan transaction.

18. If a portion or all of the funds for the down payment and closing cost come from the sale of a previous home, many lenders will require a copy of the settlement statement showing the Net To Seller and signed by all parties to the transaction. In some cases they will require a copy of the Grant Deed. If the home has not sold, the borrower will need to provide a copy of the earnest money contract on the home and, upon closing, provide the previously mentioned documents.

If a prospective homebuyer is making application for a FHA–insured loan they will be required to provide some additional information. The Department of Housing and Urban Development requires that with all applications, the lender must require the applicant to establish picture identity and evidence of Social Security numbers at the time of the face–to–face interview. In addition the letter requires the borrower to provide a paycheck stub and if there is a verification of deposit, the lender must obtain a copy of a recent bank statement(s). Copies of these documents (that is, driver's license, identification card, Social Security card, pay stubs, and so forth) must be included as part of the application package. This is a brief review of the application information that may be required by a lender. Many lenders have prepared application information checklists. You should check with lenders in your area and secure copies of any such checklists.

UNDERWRITING FORMS

What happens after the application is completed? The lender verifies the employment of the borrowers.

As with the application forms, various lenders have forms to verify employment, income, deposits, mortgage loan payments, rental history, and credit. In this discussion we will examine those forms approved or authorized by Fannie Mae/ Freddie Mac, FHA, and DVA.

VERIFICATION OF EMPLOYMENT

Fannie Mae Form 1005, Request for Verification of Employment, is shown in Form 14–3. The form is divided into three sections. The first section is to be completed by the lender. This section is usually completed at the time of application and is signed by the applicant. Normally the lender will have the applicant sign several of the forms, just in case the original form that is sent to the employer is lost. The second section of the form is to be completed by the present employer. The employer states that the applicant or co–applicant is still in his employment. You will notice that part II of the form is divided into two parts:

employment record and pay data. Line 13 of the employment section inquires about the existence of overtime and/or bonuses, and, if they are paid, what the likelihood is of their continuance in the future. Part III of the form, Verification of Previous Employment, is to be filled out by the employer only if the person signing the request is no longer an employee. This form will be forwarded directly to the employer and the employer will return the completed form directly to the lender. Do not ask the lender if you can hand carry the verification to help speed up approval; the statement at the bottom specifies that the form must be transmitted directly to the lender without passing through the hands of the applicant or any other party.

***Form 14-1:* Request for Verification of Employment**

FannieMae

Request for Verification of Employment

Privacy Act Notice: This information is to be used by the agency collecting it or its assignees in determining whether you qualify as a prospective mortgagor under its program. It will not be disclosed outside the agency except as required and permitted by law. You do not have to provide this information, but if you do not your application for approval as a prospective mortgagor or borrower may be delayed or rejected. The information requested in this form is authorized by Title 38, USC, Chapter 37 (if VA); by 12 USC, Section 1701 et. seq. (if HUD/FHA); by 42 USC, Section 1452b (if HUD/CPD); and Title 42 USC, 1471 et. seq., or 7 USC, 1921 et. seq. (if USDA/FmHA).

Instructions: **Lender** — Complete items 1 through 7. Have applicant complete item 8. Forward directly to employer named in item 1.
Employer — Please complete either Part II or Part III as applicable. Complete Part IV and return directly to lender named in item 2.
The form is to be transmitted directly to the lender and is not to be transmitted through the applicant or any other party.

Part I — Request

1. To (Name and address of employer)	2. From (Name and address of lender)

I certify that this verification has been sent directly to the employer and has not passed through the hands of the applicant or any other interested party.

3. Signature of Lender	4. Title	5. Date	6. Lender's Number (Optional)

I have applied for a mortgage loan and stated that I am now or was formerly employed by you. My signature below authorizes verification of this information.

7. Name and Address of Applicant (include employee or badge number)	8. Signature of Applicant

Part II — Verification of Present Employment

9. Applicant's Date of Employment	10. Present Position	11. Probability of Continued Employment

12A. Current Gross Base Pay (Enter Amount and Check Period)

$ ________ ☐ Annual ☐ Hourly ☐ Monthly ☐ Other (Specify) ☐ Weekly

12B. Gross Earnings

Type	Year To Date	Past Year	Past Year
Base Pay	Thru ______ $	$	$
Overtime	$	$	$
Commissions	$	$	$
Bonus	$	$	$
Total	$ 0.00	$ 0.00	$ 0.00

13. For Military Personnel Only

Pay Grade	
Type	Monthly Amount
Base Pay	$
Rations	$
Flight or Hazard	$
Clothing	$
Quarters	$
Pro Pay	$
Overseas or Combat	$
Variable Housing Allowance	$

14. If Overtime or Bonus is Applicable, Is Its Continuance Likely?
Overtime ☐ Yes ☐ No
Bonus ☐ Yes ☐ No

15. If paid hourly — average hours per week

16. Date of applicant's next pay increase

17. Projected amount of next pay increase

18. Date of applicant's last pay increase

19. Amount of last pay increase

20. Remarks (If employee was off work for any length of time, please indicate time period and reason)

Part III — Verification of Previous Employment

21. Date Hired

22. Date Terminated

23. Salary/Wage at Termination Per (Year) (Month) (Week)
Base ____________ Overtime ____________ Commissions ____________ Bonus ____________

24. Reason for Leaving	25. Position Held

Part IV — Authorized Signature - Federal statutes provide severe penalties for any fraud, intentional misrepresentation, or criminal connivance or conspiracy purposed to influence the issuance of any guaranty or insurance by the VA Secretary, the U.S.D.A., FmHA/FHA Commissioner, or the HUD/CPD Assistant Secretary.

26. Signature of Employer	27. Title (Please print or type)	28. Date
29. Print or type name signed in Item 26	30. Phone No.	

Fannie Mae
Form 1005 July 96

Verification of Deposits

Fannie Mae Form 1006, Request for Verification of Deposit, is shown in Form 14–3. This form is divided into two Sections. The first section is completed by the lender from information supplied by the applicant and is signed by the applicant, authorizing the financial institution to release the information to the lender. The second section of the form is to be completed by the financial institution. The financial institution is asked to give information about the deposit accounts and outstanding loans of the applicant. In the section dealing with deposit accounts, the financial institution is asked to give the current balance and also the average balance for the previous 2 months. There is reason for such a request. For example, if the present balance in the account is $10,000 and the average balance for the previous 2 months has been only $3,000, the lender will ask the applicant to explain the reason for the radical increase. The applicant can do this by writing a source of funds letter. A sample of such a letter will be given later. In item 1 2a, the institution is asked to give any additional information that may aid the lender in determining the credit worthiness of the applicant. This should include information about loans that have been paid in full.

The FHA/VA form entitled Request for Verification of Deposit, requests similar information as the Fannie Mae form, but once again the form is somewhat different. As with the employment verification form, the lender is required to certify that the verification was sent directly to the bank and that the form did not pass through the hands of the applicant or any other interested party.

Form 14-1: Request for Verification of Deposit

FannieMae

Request for Verification of Deposit

Privacy Act Notice: This information is to be used by the agency collecting it or its assignees in determining whether you qualify as a prospective mortgagor under its program. It will not be disclosed outside the agency except as required and permitted by law. You do not have to provide this information, but if you do not your application for approval as a prospective mortgagor or borrower may be delayed or rejected. The information requested in this form is authorized by Title 38, USC, Chapter 37 (If VA); by 12 USC, Section 1701 et.seq. (If HUD/FHA); by 42 USC, Section 1452b (if HUD/CPD); and Title 42 USC, 1471 et.seq. or 7 USC, 1921 et.seq. (If USDA/FmHA).

Instructions: Lender — Complete Items 1 through 8. Have applicant(s) complete Item 9. Forward directly to depository named in Item 1.
Depository — Please complete Items 10 through 18 and return DIRECTLY to lender named in Item 2.
The form is to be transmitted directly to the lender and is not to be transmitted through the applicant(s) or any other party.

Part I — Request

1. To (Name and address of depository)	2. From (Name and address of lender)

I certify that this verification has been sent directly to the bank or depository and has not passed through the hands of the applicant or any other party.

3. Signature of lender	4. Title	5. Date	6. Lender's No. (Optional)

7. Information To Be Verified

Type of Account	Account in Name of	Account Number	Balance
			$
			$
			$

To Depository: I/We have applied for a mortgage loan and stated in my financial statement that the balance on deposit with you is as shown above. You are authorized to verify this information and to supply the lender identified above with the information requested in Items 10 through 13. Your response is solely a matter of courtesy for which no responsibility is attached to your institution or any of your officers.

8. Name and Address of Applicant(s)	9. Signature of Applicant(s)

To Be Completed by Depository

Part II — Verification of Depository

10. Deposit Accounts of Applicant(s)

Type of Account	Account Number	Current Balance	Average Balance For Previous Two Months	Date Opened
		$	$	
		$	$	
		$	$	

11. Loans Outstanding To Applicant(s)

Loan Number	Date of Loan	Original Amount	Current Balance	Installments (Monthly/Quarterly)		Secured By	Number of Late Payments
		$	$	$	per		
		$	$	$	per		
		$	$	$	per		

12. Please include any additional information which may be of assistance in determination of credit worthiness. (Please include information on loans paid-in-full in Item 11 above.)

13. If the name(s) on the account(s) differ from those listed in Item 7, please supply the name(s) on the account(s) as reflected by your records.

Part III — Authorized Signature - Federal statutes provide severe penalties for any fraud, intentional misrepresentation, or criminal connivance or conspiracy purposed to influence the issuance of any guaranty or insurance by the VA Secretary, the U.S.D.A., FmHA/FHA Commissioner, or the HUD/CPD Assistant Secretary.

14. Signature of Depository Representative	15. Title (Please print or type)	16. Date
17. Please print or type name signed in item 14	18. Phone No.	

Fannie Mae
Form 1006 July 96

Mortgage Verification and/or Rental Verification

If the applicant has made mortgage payments, the lender will wish to verify the type of mortgage, the original date and amount of the mortgage, and the payment record of the applicant. If the applicant and/or co–applicant have rented previously, the lender will verify with the landlord, rental agent, or manager of the property the dates of the rental period and the manner of payment of the applicant or co–applicant.

Credit Verification

The credit of an applicant is verified by the lender by ordering a credit report from the local credit reporting agency. The report will give the applicant's payment history on accounts or loans held by members of the credit– reporting agency. By federal law, the applicant and co–applicant are not allowed to view their credit reports furnished to the mortgage lender. It should also be noted that if the lender rejects the application and it, along with all of the supporting data, is transferred to another mortgage lender, the credit report may not be transferred and a new report will have to be ordered from the credit reporting agency. lithe applicant or co–applicant wishes to inquire into his or her credit, he or she must go personally to the credit–reporting agency and request to view the information contained in his or her file. The applicant or co–applicant will not be allowed to view the actual file, but will be able to see an abstract of the information in the file. The cost of these reports is usually paid by the applicant or co–applicant.

Source of Funds Letter

As mentioned earlier in the section on bank account verification, if the balance in a checking or savings account has had a marked increase in the past 2 months, the lender may request that the applicant or co–applicant furnish information as to the source of funds for the increase. If the source of funds is the sale of property, the applicant and co–applicant must supply a statement outlining the source and furnish a copy of the settlement statement covering the transfer of the property.

If the additional funds were derived from a gift, then the lender may ask the applicant or co–applicant to furnish a statement stating that the money deposited was a gift and the giver does not expect the funds to be repaid.

LOAN PACKAGING/COLLATION

After the loan application is completed and the supporting documents that will accompany the application are received, the mortgage lender will then start to gather the information required for underwriting. This collection of information is sometimes referred to as ***loan packaging***. The loan package required by lenders will vary, but in the following section we will review some of the standard items that can make up a loan package.

STACKING ORDER

For the underwriter of the lender to review the documentation, the file must be placed in a particular order when presented to the lender. Should items be out of place or missing, the file will probably be rejected as presented to the lender. Since each type of loan has a separate criteria list, you should use the appropriate list.

To get a current, approved stack order list, the mortgage loan broker and processor may wish to obtain a copy from the direct lender. Each lender the mortgage broker works with will have its own particular order. The FNMA and FHLMC office locations to obtain current forms and underwriting books may be obtained from the following:

- Western Regional Office for Federal National Mortgage Association (Fannie Mae)
  135 North Los Robles Avenue, Suite 300 Pasadena, CA 91101–1701
  (800) 732–6643, or www.fanniemae.com

- Western Regional Office for Federal Home Loan Mortgage Corporation (Freddie Mac)
  21700 Oxnard, Suite 1900 Woodland Hills, CA 91367 (818) 710–3000
  or www.hud.gov

LOAN PACKAGING – CONVENTIONAL

Because many conventional lenders have their own requirements any of the following items may be included in the conventional loan package:

1. Submission letter (This is a cover letter outlining the items enclosed in the loan package. Usually, the letter will outline the terms and loan–to–value ratio of the mortgage. lithe mortgage is one to be purchased by Fannie Mae, they require a form entitled Transmittal Summary, in place of the submission letter.)

2. Loan application

3. Standard factual credit report (This credit report should be current. Many lenders require the report to be less than 90 days old and provided by an

approved credit–reporting agency. Many lenders, including Fannie Mae/Freddie Mac, FHA, and VA, have a list of approved credit–reporting agencies. It should be noted that if the credit report is from an agency not approved by the lender, the loan package may be rejected or the lender will order a credit report from the approved agency. In either case, processing or approval time will be increased.)

4. Verification of deposits

5. Verification of employment

6. If the applicant is self–employed, the following information will be supplied in lieu of the verification of employment:

   A. Business credit report

   B. Signed federal income tax returns for the past 2 years

   C. If available, an audited profit–and–loss statement and balance sheets for the past 2 years

7. Verification of previous mortgage and payment record or rental verification with payment record

8. Property appraisal on the lender's approved form

   - Floor plan and plot sketch

   - Photographs of the property. (Many lenders require several pictures of the property showing the front, back, and a view looking both ways from the front.)

11. A copy of the earnest money contract

12. If PMI is required by the lender, a copy of the PMI commitment

   - Statement of information

   - Affidavit, stating any plans to sell or rent owned property

   - Statement of occupancy

   - Verification of stock and cash value of life insurance, if appropriate.

- **Additional Forms** – Transactions involving income properties will also require:
  - Property income and expense report

FHA LOAN PACKAGING

The Department of Housing and Urban Development has established the use of the ***Uniform Case Binder***. The purpose of the Binder is to make HUD–FHA closing operations more efficient and assure that there will be only one, uniform, nationwide policy on the order of documents. If the lender is a direct endorsement lender, the order of documents is as follows:

Right Side of Case Binder (Top to bottom):

1. Cover letter or transmittal letter (if used), including a mailing label for the DE Underwriting Report (Form HUD 54118) if you want this report to go to an address other than the branch office that originated the loan.
2. Letter of Assignment, where applicable.
3. Request for Insurance Endorsement Under the DE Program (The local Field Office can provide a copy of this form).
4. Current Payment Letter (if necessary).
5. One–Time MIP Statement of Account (if applicable).
6. Form HUD–541 13, Underwriter Certification (with signature, identification number and date).
7. Special certifications or forms, if any, cited in the Underwriter Certification.
8. Copy of note with appropriate riders.
9. Copy of mortgage instrument.
10. HUD–1 Settlement Statement.
11. Form HUD–92900 (copies 1 and 4), Application for Insurance.

12. Form HUD–92900, Mortgage Credit Worksheet (original).
13. Form HUD–92800.5B, Statement of Appraised Value.
14. Uniform Residential Appraisal Report (original)
15. Photographs of property and comparable sales data.
16. Form HUD–92800, Application for Property Appraisal and Commitment.

Left Side of Case Binder (Top to bottom):

1. Form HUD–92900 (copy 7), Application for Insurance.
2. Form HUD–92900, Mortgage Credit Worksheet (carbon or photocopy).
3. Uniform Residential Appraisal Report (photocopy).
4. Mortgagee's Assurance of Completion (Form HUD–92300), where escrow was established for incomplete work.
5. Affirmative Fair Housing Marketing Plan (it applicable).
6. Copy of Builder Certification (only for “proposed” construction and “existing” construction cases involving new construction and high loan–to–value ratios).
7. Form HUD–92051, Compliance Inspection Report(s), if applicable, for an “existing” or “proposed” construction case. Include photographs of site grading and drainage.
8. Form HUD–92577, Request for Change to Plans and Specifications (if applicable).
9. Form HUD–92544, Warranty of Substantial Completion with Plans and Specifications. Include One–Year Performance Guaranty from builder on workmanship and materials.
10. Specific Condition(s) clearance documentation (i.e., local health authority approvals, termite inspection report or soil treatment certification, certificate of occupancy, etc.).
11. Ten–Year Warranty Insurance Certification (if applicable).

12. Credit Report
13. Verification of Deposit
14. Copy of bank statement
15. Verification of Employment
17. Picture identification of applicant(s)
18. Evidence of Social Security Number(s) of applicant(s) if not on pay stub
19. Sales contract
20. Remaining documents–no particular order

FAILURE TO PREPARE THE CASE BINDER, ASSEMBLE THE DOCUMENTS IN THE PRESCRIBED ORDER OR MARK THE BOXES ON THE FRONT OF THE CASE BINDER TO SHOW THE APPROPRIATE CASE CHARACTERISTICS WILL RESULT IN THE RETURN OF THE CLOSING PACKAGE WITHOUT ENDORSEMENT OF THE MORTGAGE.

Department of Veterans Affairs Loan Packaging

A VA loan package may include the following items:

1. Transmittal letter, outlining the loan and the documents that are included in the package (In some areas, the VA guaranty section requires that the documents be in a specific order.)
2. Certificate of Eligibility
3. Loan application, VA Form 26–1802a
4. Copy of the earnest money contract
5. Credit report from an approved credit–reporting agency
6. Verification of employment
7. Verification of deposits

8. A copy of the Certificate of Reasonable Value, VA Form 26–1843

9. Borrower's statement of liability (This is a statement signed by the veteran stating that if the VA approves the application for home loan guaranty, the veteran is obligated to repay the mortgage.)

Once the loan package is completed, the next step is for the package to be forwarded to the lender for underwriting, or if the originating mortgage company or financial institution has the ability or authority, the loan package will be approved or underwritten by the originator.

COMPUTERIZED LOAN ORIGINATION

With advances in automated lending services by Institutional lenders, many real estate brokers and salespersons assist buyers with loans through their computers, dubbed ***computerized loan origination, (CLO)***. This does not make you a loan officer. But your California license does permit you as agent to access lenders via a terminal tied into a lender's computer containing that lender's underwriting requirements and other essential data so that agents can help clients obtain the best financing. Agents are able to offer loan comparisons that allow borrowers to quickly see the amount of finance charges and closing costs, and to compare fixed vs. ARM rates and other loan programs and features before making a decision. Agents may collect fees and commissions, so long as these are fully disclosed to clients. However, recent court cases have ruled that collecting fees carries with it the liability for providing accurate loan information that suits the clients' needs.

The Federal National Mortgage Association, introduced its ***Desktop Originator*** for use by loan agents. This program allows loan agents to take applications at borrowers' homes or businesses with a laptop computer and pre-qualify prospects right on the spot, obtaining the same information that is obtained for the Uniform Residential loan Application covered in Chapter 14. There are many others who have followed a similar course, all designed to automate the loan underwriting process in a speedier and more efficient manner.

LOAN UNDERWRITING

After the appraisal has been completed, and any other requirements have been met, it is ready for underwriting by the lender.

Loan underwriting is the analysis or evaluation of the risk involved with a loan and matching the risk to the proper return.

The individual (or individuals) who assembles and analyzes the pertinent data and is authorized to give a company's approval of a specific loan, to a specific borrower, secured by a specific property, is the ***underwriter***.

In making an underwriting decision the underwriter must determine the degree of risk to the lender. The degree of risk will influence the loan–to–value ratio, the length of time for repayment, and the interest rate. The underwriter considers following:

- Borrower's credit and ability to repay the loan.
- Market value of the property in relation to the loan.
- Neighborhood and improvements surrounding the subject property.

☞ ***The practice of redlining is prohibited.***

This is a form of economic discrimination that operates by not lending in areas which are "declining"–and which usually need the money most.

CHARACTERISTICS OF UNDERWRITING

The purpose of underwriting is to determine if the property is acceptable by lender standards, if the market value supports the loan requested, and if the loan meets the lender's policies. The lender may alter the terms or conditions of the loan to comply with standards and policies. For example, if the appraisal indicates that the roof leaks, the lender may add a condition to the loan approval that the roof be repaired.

The lender also has an interest in the future value of the property, because, in case of foreclosure, there must be sufficient value to cover the loan. On one– to four–unit properties, estimating future value becomes very subjective and imprecise. Therefore, lenders are concerned about only the early years of the mortgage. If the underwriter is certain, and able to document, that value will likely decrease during the first one to five years, then the terms of the loan may be adjusted (such as reducing the loan amount). The adjustments should not exceed the minimum required for the property to be an adequate security. Underwriters are very careful not to violate State of California regulations when making adjustments or in their general underwriting.

CONVENTIONAL LOANS

Conventional loans are approved either by authorized individuals or by a committee. If it is an individual, she or he will have the authority to approve loans up to a specified amount. For example, a branch manager of a commercial bank or savings bank may approve home loans up to conforming limits. Any loan exceeding these amounts would be referred to the next level.

FHA AND DVA LOANS

FHA and DVA operate in a similar manner. After the lender has assembled the loan package, it is forwarded to the nearest FHA or DVA office. The packages are given to the mortgage credit sections, where personnel qualify the borrower. Individual loan examiners analyze each loan. If they are unable to make a decision because additional information is needed, they will request it from the lender in writing. If the borrower is qualified, they mail the approval to the lender. If the examiner concludes that the borrower cannot qualify, the loan is given to a supervisor. If the supervisor concurs, the loan is rejected. One person may approve a borrower, but it takes two people to reject the loan.

When borrowers are approved by these lenders, they should in turn be automatically approved by the appropriate agency. That is why this method of approving loans is referred to as ***DVA automatics.*** The major advantage of a DVA automatic is that it reduces the time it takes to get the loan approved involving "in–house underwriting." The loans are approved automatically only if all requirements have been met; if the package is deficient, it will not be approved. Through ***"direct endorsement,"*** this automatic approval is also available for FHA loans.

ON–LINE LOAN

With the recent surge of Internet use, coupled with heavy website advertising by lenders and mortgage brokers, many consumers are obtaining real estate loans on–line. As this trend continues to expand, it should diminish the financial advisory role of real estate sates agents, and also reduce the need for face–to–face interaction between borrower and lender. Welcome to the world of cyber space underwriting!

IF A LOAN IS TURNED DOWN

Depending on the circumstances, a borrower whose loan application is denied might consider various alternatives to make the transaction more acceptable to a lender.

- **Information** – Submit additional qualifying information to the lender, if available.
- **Re–Application** – Apply to another lender, and/or apply for a different type of loan.
- **Diminish Debts** – Sell some encumbered assets. Long term debts can hurt a buyer who is trying to qualify for a new loan.
- **Junior Financing** – Encourage the seller of the property to take back a second trust deed (and maybe even a third trust deed at a different interest rate or loan period).
- **Down payment** – Increase the amount of the down-payment. Price. Encourage the seller of the property to lower the price. Obtain another appraisal, when the first appraisal seems high.

  Credit Rating – Obtain a copy of the credit report received by the lender and correct any misinformation which caused the loan to be turned down.
- **Co–Mortgagor** – Obtain a co–signer to supplement the income qualification.

CLOSING THE LOAN

If a loan is approved, the mechanics of closing the loan are usually coordinated through escrow or either by the lender's in–house escrow department, by an outside escrow company, or by an escrow department of a title insurance company.

A complete escrow includes written instructions by the borrower and lender as to what is to be done to close the loan.

ASSEMBLY OF REPORTS

Escrow usually gathers together all required reports and information for review and approval by the parties involved. These typically include:

- Statement of identity – A title insurance company frequently requires a statement of identity to distinguish a principal from other persons with a similar or identical name.
- Down-payment, in the form of a cashiers check.
- Title report, showing condition of title as to conditions, covenants and restrictions (CC&Rs), claims of record, etc.
- Beneficiary statement or demand for payoff from the seller's lender.
- Offset statement from the property owner, when existing loan documents are being sold.
- Property tax information.
- Survey, if required, showing exact location and physical condition of the property.
- Home inspection report, if one has been made.
- Fire insurance policy.
- For income property, a statement of all rental payments, tenant deposits, etc., and proration of rents.
- Structural pest control report and certificate of completion, if appropriate.

Escrow assembles all the necessary documents, properly executed and notarized. Frequently, escrow officer prepares these documents as needed. Escrow also checks to see that all signers of the documents have capacity to sign.

Documents Prepared by Lender

After the loan is conditionally approved by the underwriter the following documents are prepared and require the borrower's signature:

- Original note and deed of trust
- Loan escrow instructions
- Any amendments to loan escrow instructions

- Certification amendment to loan escrow instructions
- Truth in lending disclosure form
- Insurance authorization and requirement chart
- Loan application for final signature

The promissory note outlines the financial terms of the loan: amount of loan, interest rate, monthly payments, date of first payment, and so on. The promissory note also lists other conditions such as late charges, prepayment privileges and penalties, and acceleration clauses.

A deed of trust is used to secure the repayment of the loan by creating a lien against the property. As explained in an earlier chapter, deeds of trust are used in California instead of mortgages, because of the ease with which a lender can foreclose in case of a borrower's default.

A deed of trust shows only the loan amount, not the interest rate, monthly payments, and so on. The deed of trust recites that, if the debt it secures is not paid, the property may be sold to satisfy the debt. The deed of trust is recorded, while the promissory note is not. Thus, to maintain confidentiality between the lender and borrower, the deed of trust shows only the amount of the loan, not the repayment terms. In addition, the deed of trust contains many other detailed agreements between the borrower and lender.

HUD Education Materials

HUD publishes a Homebuyer’s guide, chapter 5 explains how you can help your clients prepare for the loan closing. The completed curriculum is attached in appendix B for your review. (available in our CD version only, the CD will be included in your book too).

☞ ***For more information please visit their website at www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/chapter5.pdf***

FUNDING THE LOAN

The lender's escrow instructions are sent to the escrow officer, then back to the lender for the lender's funding review. When final approval is given, the check is issued to the escrow officer; the loan is "funded."

- **Recordation** – When all instructions have been compiled, the escrow officer sends documents to be recorded to the county recorder's office, usually through a title company.
- **Closing Statements** – Statements are rendered to the parties at close of escrow, itemizing the disposition of all funds received and expended by the escrow–holder.

CLOSING COSTS

The escrow officer calculates all charges to all parties and collects all funds necessary. Initial closing statements are prepared, containing estimates where final amounts are not known.

Closing costs are divided into those that occur only once, at the time of the loan, and are therefore labeled ***nonrecurring***; and those that are ongoing, that is, continue beyond the close of the loan transaction, and are therefore labeled ***recurring*** closing costs.

NONRECURRING CLOSING COSTS

The following costs are *one–time charges* that the buyer–borrower usually pays at close of escrow. However, it must be stressed that the payment of closing costs is negotiable between the buyer and seller.

- **Loan Origination Fee** – This fee compensates the lender for some of its expenses in originating the loan, preparing documents, and related work. The fee is usually a percentage of the loan.
- **Title Policy** – Title policies are issued by title insurance companies, insuring buyers' and lenders' interests in the property against defects of title. There are two basic types of coverage in California–the California land Title Association or CLTA, and the American land Title Association or ALTA. Most lenders require the ALTA policy because it provides additional

coverage for the lender. Who pays for the CLTA or standard title policy varies in California. For example, it is customary for the seller to pay in Los Angeles and Orange counties; in Contra Costa and San Francisco counties, it is customary for the buyer to pay. There are other counties, such as Merced and San Joaquin, where the cost is split between buyer and seller. In our example, the buyer is paying for the policy. Buyers normally pay for an ALTA policy. However, it must be stressed that regardless of custom, the issue of who pays can always be negotiated.

- **Escrow Fee** – The escrow fee is charged for handling and supervising the escrow. As with title policies, custom also tends to dictate who pays the escrow fee. The buyer is paying the entire fee in our example, though in reality escrow fees are often split in some fashion between buyer and seller.

- **Credit Report** – The lender obtains a credit report in qualifying a buyer. The cost of the report is usually charged to the buyer.

- **Appraisal Fee**– The cost of the appraisal varies with the type of loan and property.

- **Tax Service Fee**– This fee is paid to a tax service agency that, for the life of the loan, each year reviews the records of the taxing agencies. If a borrower fails to pay the property taxes, the agency reports this to the lender. If the lender is paying the taxes for the borrower, the agency also obtains the tax bill for the lender.

- **Recording Fees** – These cover the cost of recording the grant deed and deed of trust reconveyance.

- **Notary Fees** – Signatures on documents to be recorded, such as the grant deed and deed of trust, reconveyance.

- **Pest Control Inspection Fee** – The buyer or seller may pay this charge, depending on local custom. The charge varies from area to area but is always negotiable.

Recurring Closing Costs

Recurring closing costs are the expenses the borrower also pays at closing. These expenses continue as long as the borrower owns the property, and includes items such as taxes, insurance, interest, and rents.

- **Tax Reserve** – This item is also called an impound, escrow, or trust fund account. A tax reserve is collected when the monthly loan payment will include not only principal and interest but also taxes and hazard insurance. On certain loans such as FHA and high (95 percent) LTV ratios, the collection is mandatory. In other cases, buyers may request that their payments include taxes and insurance. This is a depositor's own account; the bank does not control it. As the lender collects these funds each month, they are set aside. When the tax and insurance bills become due, the buyer/owner pays them out of the accumulated funds. To the borrowers, these funds are like their own bank account and are not under the disposition of the lender. Lenders must pay 2% interest on impound accounts when they collect.

  If loan payments are to include taxes and insurance, the lender sets up a tax reserve at time of closing. The amount of reserve collected varies according to the date of the first monthly payment. Lenders use schedules to determine the tax reserve. A typical tax reserve schedule appears in Figure 14–1.

  Why do lenders need what appears to be a one–month cushion? lenders with impound accounts must pay property taxes by December 10 and April 10, or the taxes become delinquent. If the lender relied solely on the December and April payments, it might not have enough in the account to make the proper payments, since the borrower has a 15–day grace period. Thus, the lender has a **"**right**"** to the one–month cushion.

- **Tax Proration** – Most sales agreements provide for proration of taxes between buyer and seller. When the taxes are prorated, the seller must reimburse the buyer for any portion of the seller's taxes paid for by the buyer. The seller is responsible up to, but not including, the day of COE. Buyer is responsible from day of COE. Proration is based on banker's date of 30 days a month, 360 days a year.

- **Hazard Insurance Premium**. Lenders require that the property be covered by insurance against loss due to fire, windstorm, and natural hazards. In special flood–prone areas, flood insurance may also be required. The buyer pays the premium for the first year at close of escrow.

Insurance companies in California are under the regulation of California Department of Insurance.

☞ ***For complete insurance regulation details please visit their website at*** ***www.insurance.ca.gov***

- **Hazard Insurance Reserve**. When the monthly payments include insurance, a two–month reserve is usually collected.

- **Prepaid Interest**. The loan's closing date is October 15, and the first monthly payment is December 1. The payment due December 1 covers the interest due for the month of November. The interest due from October 15 to October 31 is collected in advance at close of escrow and is called prepaid interest. If the escrow closed on October 31, there would be one day's interest if the lender funds the loan in advance of closing. For lenders, this is one of the few circumstances in which interest is collected on a calendar–day basis. In all other cases, real estate lenders use 30–day months when computing interest (as provided under the Civil Code).

ELECTRONIC LOAN PROCESSING UNDERWRITING SYSTEMS

With the advent of the home computer and the possibilities of the Internet, it was inevitable that real estate loan processing would become electronic. Although it's quickly expanded from lenders communicating with FNMA and FHLMC, to individuals applying for a loan from their home desk computers, electronic loan processing still requires that the applicant's credit be approved and that the loan's collateral be appraised. But now these tasks can be accomplished in seconds and minutes rather than hours and days. In other words, progress is measured in terms of speed and efficiency.

In 1995 FNMA offered its automated underwriting system to its loan servicers. FNMA's system followed closely behind FHLMC's loan preparation system; however, FNMA offers two levels of programming, one for lender servicers and the other for independent mortgage broker–agents, called the desktop originator–desktop underwriter. Lenders access FNMA's sophisticated loan analysis system through software purchased from FNMA. Estimated loan approval time runs from 60 seconds to 30 minutes, but the originator must fax verification information–including pay stubs, two years of W2 forms and three monthly bank statements.

Included in the process is credit scoring. The applicant's score is based primarily on data in one or more of the national repository files maintained by Experian (TRW), Equifax or Trans–union. Some factors included in scoring models, include behavioral data based on number of jobs held, length of time in present home, marital status, etc. The scores on the FICO test (named after Fair, Isaac & Co., the San Rafael, California–based firm that created the test) run from 400 to 900, the higher the score, the better the credit. The scores on what is called the MDS test run from zero to 1,300, with the lower score indicating better credit. Lenders may order either or both scores electronically at relatively low cost from credit repositories or bureaus. FICO scores are known as Equifax Beaconsm, Trans Union Empiraca and TRW/FICO. MDS scores are known as Equifax Delinquency Alert System, Trans Union Delphism and TRW/MDS.

Potential misuse of credit scoring has prompted the following three rules on their use:

1. Never automatically disqualify anybody due to a sub-par credit score.
2. Be aware of potential errors in electronic credit files.
3. With a sub-par score, look hard at the score factor codes and work with applicant to clear **"**fixable**"** items.

The property is never viewed as to condition or external factors. Rather; the property is appraised by a collateral assessment, which uses statistical analysis, including regression analysis, and compares property features with others that have recently been sold. Success of this approach is yet to be proved.

FAIR CREDIT REPORTING ACT

The federal **Fair Credit Reporting Act** affects credit reporting agencies and users of credit information. If a loan is rejected because of information in a credit report, the borrower must be notified and given the name and address of the credit agency. The borrower then has the right to obtain from the agency the following:

1. All the information it has in its file on the borrower
2. Sources of the information

3. All the creditors to whom the agency has furnished reports within the last six months

If an error is found, the credit agency must correct it quickly. If there is a dispute over a debt, the agency must include the borrower's side of the story, called a Consumer's Statement.

Loan Subject To's (Seller Liable)

Where property is purchased "subject to" the existing loan of record, the buyer does not agree to assume primary liability for the debt. Instead, the seller continues on the obligation; that is, although the buyer makes the payments directly to the lender, the ***seller remains responsible for any deficiency***, if a judgment is obtained.

As a practical matter, however, even though the buyer is not obligated to make the payments, the buyer will naturally continue the payments in order to keep the property. This is because the debt is secured by the property, and the lender's security is held intact regardless of who makes the payments. Thus, if the buyer fails to make the payments, the lender proceeds against the property through foreclosure. The only time that the distinction between "assumption" and "subject to" becomes important is when the foreclosure results in a deficiency. If a deficiency judgment is obtained, the lender could proceed only against the maker of the note, the seller, if the buyer purchased subject to the existing loan. Had the buyer assumed primary liability for the debt, the buyer could be held liable for the deficiency.

Loan Assumption (Buyer or Both Liable)

A real estate loan is *assumed* when the new borrower is approved by the lender and a formal assumption agreement is executed. When a loan is assumed, the original borrower–the seller–can be relieved of responsibility, provided *release of liability* is given. In other words, if the original borrower wants to be relieved of liability, the new borrower must formally assume the loan and the original borrower must obtain a release of liability. Unless there is a complete novation, ***both parties could be liable*** on a formal assumption. Loans can be formally assumed by applying to the lender.

If the note and trust deed contain a due–on–sale clause, the FHA and the DVA must approve requests for assumption. Specific procedures have been set up by these agencies to process assumptions. On a DVA loan, the new borrower must be a veteran with appropriate entitlement if the seller is to be relieved of primary liability. Assumption under Cal–Vet is accomplished when another eligible veteran qualifies for a new loan on the same property and in the same amount as the old one, but at the then–current interest rate. Technically this is not a loan assumption; rather, it is a *new* loan.

Loan Payments Due

Loan payments are usually due on the first of each month. After the loan is closed, the borrower is notified as to how to make payments. There are basically two methods lenders use to collect payments. One is the *monthly billing system.* Before the first of each month, lenders mail a notice of payment due. Borrowers mail payments with the notice. The second method is the use of *coupons.* Each month, borrowers send in the monthly payment and enclose a coupon furnished by the lender.

After the first of the year, most lenders give borrowers a yearly statement for the previous year. The statement shows the principal, interest, taxes, and insurance, if included in the payments, that were paid during the year. If taxes and insurance are included in the payment, a reserve analysis is also included. The analysis calculates the amount of tax and insurance reserve that should be in the reserve account.

If there is a shortage due to a tax increase, the lender may ask that the shortage be made up immediately. A more common practice is to spread the shortage over the next 12 months along with the required increase for the future. For example, assume a borrower had a shortage of $180 in the reserve account. Rather than demand the entire $180 immediately, the lender would increase the monthly payment by $15, which would make up the shortage in one year. In addition, an adjusted amount would be collected for any shortages expected in the following year. If there is a surplus in the account, the borrower may either apply it to a future mortgage payment, ask for it in cash, or apply it against the principal.

In addition to checking the reserve balances, the lender also analyzes the monthly payment. The payment may be increased or decreased if there has been a change in taxes or insurance premiums.

Late Charges

When borrowers fail to make payments on time, lenders may collect late charges. The amount of the late charge and when it is collected is stated in the promissory note or deed of trust and on the payment coupon. Late charges by type of loan are as follows:

- **FHA and DVA** – Four percent of the monthly payment if not paid within 15 days of the due date. If the payment, including taxes and insurance, were $1,000 per month, the late charge would be $40.

- **Cal–Vet** – Payments are late if made after the 10th of the month. The late charge is a flat $4.
- **Conventional Loans** – Late charges on conventional loans vary. The State of California has a civil code provision that limits late charges on single–family, owner–occupied dwellings to 6% of the principal and interest payment. The borrower must be given a minimum of 10 days to make payment.

DEFAULTS

It is generally accepted that most lenders do not want to own the real estate that is pledged as collateral for their loans. However, defaults do occur, even though most lenders will expend every effort to qualify their borrowers in order to ensure the success of their loans. Some lenders inevitable will encounter defaults on their loan portfolios. A default is breaching of a term of a loan agreement.

When borrower defaults, the lender will exercises the acceleration clause contained in all loan documents which allows the lender to declare the full amount of the debt immediately due and payable.

If the borrower cannot meet his/her payment scheduled, the lender is empowered to foreclose against the collateral to recover any loss. Although legally any default in a loan contract enables the lender to accelerate the debt, most lenders will seek to avoid foreclosure and arrange a plan with the borrower that will protect the interests of both parties and avoid costly foreclosure procedure.

DEFAULT IN MORTGAGE PAYMENT

The most common form of default occurs when the payment of mortgage is not made upon due.

Almost all loan contracts stipulate that the regular payment is due **“**on or before**”** a specified date, but most lenders will give an additional period, called **grace period**, usually from ten to fifteen days, in which to receive the regular payment.

Many loan contracts include a **late payment charge** of some specific amount that is applied if the borrower exceeds the grace period. This late payment fee is imposed to encourage promptness and to offset the extra bookkeeping costs that delinquent accounts entail. Most lenders are not disturbed by payments made within grace periods, but they will take remedial action when an account consistently incurs late charges or when a borrower exceeds a 30–day delinquency period.

DEFAULT IN MAINTAINING PROPERTY

To protect the trustee holder of the property, most trust deed requires the trustor to maintain the property in a good condition. This will preserve the value of the property as a collateral for the repayment of the loan.

DEFAULT IN FIRE INSURANCE PAYMENT

Again, to protect the security of the loan, most trust deed requires the trustor to maintain a basic fire insurance policy. The policy includes a “mortgage loss payee” clause in favor of the beneficiary. When a trustor/borrower fails to maintain the insurance policy in force to satisfy the beneficiary, the beneficiary may obtain a policy and charge the premium to the trustor. If a borrower fails to make such “advance” payment, the lender has the option to accelerate the loan, call the principal immediately due and payable.

Again, the impounding technique prevents most of the possible difficulties in this area, but some real estate loan arrangements allow the borrower the flexibility to pay insurance premiums independently. In such case, the borrower is obligated to make the premium payments on time to prevent any lapse of coverage and is usually required to provide the lender with a copy of the evidence of insurance.

DEFAULT IN PROPERTY TAXES PAYMENT

Another frequently encountered default with real estate loans is the nonpayment of property taxes. Although this situation is not too prevalent with residential loans due to the effectiveness of the impounding technique, it becomes a more serious problem with commercial real estate financing in which impounds are generally not required.

The nonpayment of property taxes is a technical default under a real estate loan. Property taxes represent a priority lien over most existing liens on real estate. If a tax lien is imposed, the lender's position as priority lienholder is jeopardized. If a lender is unaware of a property tax delinquency and, thus, is not protected, the collateral property may be sold for taxes. As a consequence, all realty loan agreements include a clause stipulating a borrower's responsibility to pay property taxes in the amount and on the date required. Otherwise, the lender is notified by the county treasurer, and the loan goes into default and may be accelerated.

FORECLOSURE SALE

When everything fails, the last recourse available to a lender is to pursue legal proceedings to recover the property. This procedure is foreclosure sale and it may be accomplished through either nonjudicial sale or judicial sale.

NONJUDICIAL FORECLOSURE PROCESS

When a borrower defaults on the payments, the lender's right can be enforced through the "power of sale" clause contained in the deed of trust. This is also called the "nonjudicial foreclosure", or "trustee's sale". In trustee's sale, no court action is required, and the trustee is generally given the power of sale.

Trustee's sale is preferred by lenders as it does not involve a lengthy procedure as in a judicial mortgage's foreclosure.

The trustee's sale process is outlined below:
A lender has the legal right to receive the trust deed payment on time. The lender can start default action after a **10-15 day** grace period. The grace period is a set number of days in which a lender will allow a payment to be late without any penalty. The lender, at any time after the grace period, may start default action against the trustor.

The default action a lender can start is the trustee's sale. (A lender has the option of a judicial foreclosure, the same remedy available with a mortgage, but this is rarely used in California.) A trustee's sale of property hypothecated as a security for a debt is made possible by the provisions of the trust instrument. On default by the trustor, the beneficiary informs the trustee of that fact by a "Declaration of Default", which states the reason for the default. The beneficiary includes the original note and trust deed with the declaration.

The "notice of default" is recorded by the trustee and sent by registered or certified mail to all of the following:

- The trustor.
- Any successor in interest to the trustor.

- Junior lien holders.
- The State Controller (if there is a tax lien on the property).
- Anyone who has filed a ***"request for notice*"** with the county recorder.

Request for Notice (Protects 2ND TD Holders)

When a **"**request for notice**"** is recorded, the trustee is required to notify all persons who request notice if a **"**notice of default**"** is recorded on a particular property

Any person who has an interest in a particular trust deed, usually a second or third trust deed holder, should be informed if the buyer is not paying on the first trust deed. This information not only informs the junior deed holders of nonpayment on the first trust deed, but it also allows them time to prepare to purchase the trust deed at the forthcoming trustee's sale. It will also give them time to start default actions on their own junior trust deeds.

This request for notice is recorded in the county recorder's office where the property is located. If a seller takes back a second or even a third trust deed, thereby becoming a junior trust deed holder on the property that person has just sold, that person would be wise to record a request for notice. Some request for notice forms are incorporated into the trust deed form, so the request for notice is automatically filed.

Trustor's Right of Reinstatement

A debt under a trust deed can be reinstated by a trustor if payment of the overdue amount is made at any time after the notice of default is recorded, but no later than five business days prior to the date of sale in the subsequent recorded notice of sale**.**

Reinstatement within the five-day period preceding the sale would be at the discretion of the beneficiary and might still be allowed.

☞ ***Once reinstated, the trustor is again in good standing.***

Notice of Sale (21 Days)

No less than three months after the *notice of default* is recorded, a **"Notice of Trustee's Sale"** is given in the same manner as the notice of sale in a foreclosure. During the three month reinstatement period, the trustor may reinstate the loan.

The Notice of Sale is a recorded notice stating the time, place, property description and type of sale. The notice must be published in a newspaper of general circulation once a week, not more than seven days apart, during the 21-day publishing period. A copy of the notice must also be posted on the property and in a public place, such as the city hall.

TRUSTEE'S SALE (FINAL)

A trustee's sale is an out of court procedure under the ***"**power of sale clause**"*** in the deed of trust and promissory note. The trustee's sale is held at the time and place stated in the notice of sale. At the public sale, the trustee states the purpose of the sale and describes the property to be sold. All bids must be in the form of cash or cashier's checks. The first deed holder may bid up to the total amount of the debt without cash. Because it costs the first trust deed holder nothing more than what he or she is already owed, that person will usually make the first bid. The highest bidder obtains the property and will be issued a trustee's deed. Any money more than the amount owed is reimbursed to the trustor. The new owner is entitled to immediate possession.

At the sale itself, payment to the amount of the debt owed is by cash, cashier's check from a qualified lender or a cash equivalent designated in the notice of trustee's sale as acceptable to the trustee.

Figure 14-1 Trustee's Sale Timetable

TRUSTEE'S SALE TIMETABLE

10-15 DAYS	**3 MONTHS**	**21 DAYS**	**1 DAY**
Notice of Default	Reinstatement Period (Waiting Period)	Notice of Sale Publishing	Trustee's Sale

JUDICIAL FORECLOSURE /MORTGAGE FORECLOSURE

Although mortgages are rarely used in California, it is important to understand its foreclosure procedure.

A mortgage is foreclosed by initiating a court action for judicial foreclosure, unless it explicitly includes a power–of–sale clause, as appears in a trust deed, which eliminates the need for a judicial action.

Equitable Redemption (Reinstatement Rights)

Right of Equitable Redemption/Redemption Period

The most significant difference between a mortgage and a trust deed sale is that there is **no** right of redemption following a trustee's sale. The sale is absolutely final, and the purchaser can take possession immediately. However, if the former owner refuses to vacate the premises, an *unlawful detainer* is the legal action by which the court orders the sheriff to evict the present occupant. The purchaser at a trustee's sale must also take such an eventuality into account.

While, under a judicial foreclosure, a borrower may cure the default and reinstate the loan any time before the entry of judgment by paying the delinquencies plus costs and fees. This immediately stops the foreclosure proceedings, and the loan continues in full force and effect as though no acceleration had taken place.

A mortgagor has up to one year to redeem following court foreclosure; called "Equity of Redemption."

Deficiency Judgment (Not Available in Trustee's Sale)

Under limited circumstances, the lender may get a judgment against the borrower if the property is sold at the court foreclosure sale for less than what is owed on the loan.

A **deficiency judgment** is the deficient difference between the money that a property brings at a court foreclosure sale and the amount owed on the property. If a home was sold at a court foreclosure sale for $217,000 and $240,000 was owed on the property, a lender would have a $23,000 deficiency judgment against the borrower. If it were a purchase money instrument, however, there would be no deficiency judgment.

During the redemption period, the borrower may remain in possession of the property but must pay rent. Sometimes a lender may take possession of the collateral under the assignment of rents provision in the loan contract, manage the property during the redemption period and apply the net proceeds to the balance owed.

☞ INTERNET WEB LINKS

www.foreclosurefreesearch.com	Foreclosures, bank and government–owned real estate. ...
www.insurance.ca.gov	Regulations for insurance companies, and insurance licensees

CHAPTER QUIZ

1. Processing an application for a real estate loan includes verification of

   A. Employment.
   B. Deposits.
   C. Debts.
   D. All of the above.

2. The last step in originating and processing loans is

   A. Formal closing.
   B. Qualifying the buyer.
   C. Completing the application.
   D. Qualifying the property.

3. The trend toward on–line loan services is

   A. Making the real estate loan market less competitive.
   B. Reducing the choice of financing packages for borrowers.

C. Not subject to government regulations.
D. Expected to increase in the future.

4. Which of the following would be the most important information sought by lenders about a potential borrower?

A. Age of the borrower
B. Desire for a loan
C. Credit history of the applicant
D. Overtime income

5. All of the following would generally constitute default on a trust deed with the ***exception*** of:

A. Delinquent property taxes
B. Failure to make loan payments
C. Allowing insurance policies to lapse
D. Placing a junior lien on the property

6. Under the Equal Credit Opportunity Act, lenders are required to notify applicants what action has been taken within a reasonable time period not exceeding

A. two weeks.
B. 30 days.
C. three months.
D. any time mutually agreed to between borrower and lender.

7. The most common cause of loan defaults is due to a borrower unable to

A. Pay the property taxes when due.
B. Pay the mortgage payments when due.
C. Pay the property insurance premium when due.
D. Maintain the collateral.

8. A foreclosure will usually be initiated when

A. A borrower has died.
B. A borrower has lost his or her job.
C. The value of the collateral has dropped below the balance of the loan.
D. A borrower can no longer make payments, and the value of the collateral has dropped below the outstanding balance of the loan.

9. After an FHA–insured loan is foreclosed, any of the following may transpire, ***except***

   A. The FHA will reimburse the lender in full and in cash.
   B. The FHA will reimburse the lender in full and in debentures.
   C. The lender will secure title to the property and assign it to the FHA.
   D. The lender will secure title to the property, refurbish it and sell it.

9. After a judicial foreclosure sale

   A. all rights held by the trustor are terminated
   B. The successful bidder gets fee title, free of any restrictions
   C. The trustor has a three-month right of reinstatement.
   D. The trustor has a one-year right of redemption

10. A trustee may initiate a foreclosure sale as a result of

   A. The provision of the California Business and Profession Code
   B. The applicable sections of the Civil Code.
   C. The power of sale contained in the deed of trust .
   D. The violation of the due-on-sale clause.

Answers: 1–A, 2–C, 3–B, 4–B, 5–B, 6–D, 7–C, 8–C, 9–D, 10–C

CHAPTER 15: REFINANCING OR NOT AND CHOOSING A LENDER

PREVIEW

There is a wide variety of loan types available to the broker for use in completing transactions. The general principle which governs is, **"**The greater the risk to the lender, the higher will he the interest, the shorter the maturity and the lower the ratio of loan to value.**"** And, as an auxiliary rule, **"**The better the property and creditworthiness of the borrower, the more benefits will accrue to borrower, with a wider range of loan plan choices. An individual who has not saved money is forced to pay a higher price for goods purchased and real estate is no exception.**"** (California Department of Real Estate, Reference Book)

Borrowers often are faced a common question "Should I refinance or not refinance my existing mortgage?". And if upon decided to refinance, borrowers face yet another task on choosing a right lender. This chapter will review the pros and cons on refinance and what kind of questions a borrower should ask during refinance.

REASONS TO REFINANCE

INTEREST RATE REDUCTION

One of the best reasons to replace an existing loan with a new one is to obtain a better interest rate. If market interest rates are down, an existing loan at a higher rate can be a considerable disadvantage. A simple chart showing the payments on a loan of $100,000 at different interest rates shows that a change in interest rate can result in a significant change in the monthly payment, with the change being slightly greater at higher interest rates.

Monthly Payments on a Thirty Year $100,000 Loan at Different Interest Rates

Interest Rate	***Monthly Payment***	***Increase over 1% Lower***	***Increase over 2% Lower***
8%	$733.77		
9%	$804.63	$ 70.86	
10%	$877.58	$ 72.95	$ 143.81
11%	$952.33	$ 74.75	$ 147.70
12%	$1,028.62	$ 76.29	$ 151.04
13%	$1,106.20	$ 77.58	$ 153.87
14%	$1,184.88	$ 78.68	$ 156.26
15%	$1,264.45	$ 79.57	$ 158.25
16%	$1,344.76	$ 80.31	$ 159.88

2% Rule of Thumb

Many advisors proffer the general rule that it pays to refinance when the interest rate will drop by at least two points (2%) and the cost of refinancing can be recaptured through savings in monthly payments within 36 months.

Using the preceding chart in applying this rule of thumb, the borrower should consider refinancing this $100,000 loan to get a reduction from 13% to 11% if the loan costs did not exceed approximately $5,500. Since the costs of refinancing vary among lenders, the property owner considering refinancing should shop several lenders. Many real estate brokers make a special effort to remain current about what the different lenders are offering in the market. Mortgage brokers specialize in being current about the market. Remember, also, that the 2% rule is only a “rule of thumb” and may not be the best guide in all situations.

Escaping an ARM

- **Greater Risk** – The adjustable rate mortgage evolved from lenders' efforts to create mortgage instruments in which the borrowers would accept at least a part of the risk that interest rates might rise to levels higher than extant at the time the loan is negotiated. Lenders had been “burned” in the early 1980s when, in order to attract deposits, they had to pay interest rates on deposits higher than the rates received on existing loans, lower interest rates were offered to borrowers who would accept the risk of higher interest rates in the future by accepting variable or adjustable interest rate provisions. These loans were made even more attractive to borrowers by offering “teaser” rates for a very short term, usually until the first adjustment period. The ultimate inducement, then, was to qualify the prospective borrower on the basis of the teaser rate, enabling the buyer/borrower to qualify for a much larger loan and thus a much higher priced home.

- **Reducing Risks** – Property owners encumbered with ARM loans can reduce that added risk they have assumed by refinancing with a new fixed–rate loan. Clearly this procedure is most attractive at a time when market fixed rates are relatively low. Some economists suggest that 7% plus the projected rate of inflation is an attractive fixed–rate interest.

Tax–Free Cash

- **Increased Equity** –The appreciation rate in real property values in California has been generally greater than the overall inflation rate. Homeowners who have owned their homes for several years usually find that their equities have increased enormously. It is not unusual for an owner who paid $80,000 for a home to find that same home to be valued at $250,000. Clearly the owner has “made” a great profit. If the owner “realizes” this profit through the sale of the home, there is a capital gain, which is subject to tax consequences unless the owner rolls the gain over into another personal residence of equal or greater value. Even the once–in–a–lifetime age exemption would not exempt all of the gain in this example. An installment sale would only defer the gain by spreading it out over a period of time.

- **Tax–Free Income** – Refinancing does not usually give rise to tax consequences. Therefore, through refinancing, the owner realizes cash from this profitable investment by generating income that in most cases is tax–free income. (An exception is if the loan is “forgiven” or goes into default. The IRS would consider such a loan to be taxable income to the property owner.)

Balloon Payment

- **The “Easy Pay” Plan** – If a loan is written with monthly payments to be made as if the loan were to be paid off over 30 years, but with the final payment of the balance due in five years, the payments are much easier to make (lower) than if the loan were to be fully amortized with level monthly payments over five years. That is, all of the payments except the last one will be easier to make.

- **Payoff** – This property will have to be refinanced to pay off this required balloon payment.

- **Seller Carry–Back** – A seller who **"**takes back**"** a second mortgage (trust deed) may want a **"**short fuse**"**–a balloon payment to be due within four or five years. Such loans are easier to **"**cash out**"**–sell to private investors looking for short–term investments in the secondary money market. Trustors of these loans are faced with the requirement of early refinancing. Some economists recommend that a buyer/borrower try to obtain at least a seven year period before a balloon payment.

Planning For Sale

- **Assumability** – An owner planning to sell a home, or an investor planning to exchange a business or investment property, can enhance the salability of the property by encumbering the property with a large new assumable loan at attractive terms. Combine this objective with the objective of acquiring tax–free cash, and the property owner is a good candidate for refinancing.

REASONS NOT TO REFINANCE

No Real Advantage

- **Good Existing Terms** – A current loan written with good terms should not be disturbed when it is possible to avoid it, whenever any loan is paid off, the trustor is required to come up with cash. As a general rule there is an economic advantage to avoid coming up with cash. The **2%, 36 month rule** should be applied unless there are other persuasive reasons to refinance.

- **Prepayment Penalty** – A lender is likely to waive a prepayment penalty if the loan being paid off is at an interest rate *lower* than the current market rate. The lender would naturally like to eliminate a less profitable loan. Conversely, a lender is not likely to waive a prepayment penalty written into a more profitable (higher interest rate) loan. California Civil Code § 2954.9 provides that a prepayment penalty provision may not extend beyond five years on an owner–occupied dwelling of not more than four units. In any 12–month period during those five years the borrower may pay off up to 20% of the original principal amount without any penalty. The lender may charge up to six months' interest on any amount in excess of that 20% in that year. For loans limited by the Broker's Loan Law, the prepayment provision may extend through seven years. Even with the limitations, however, a prepayment penalty can drive up costs of refinancing heavily. On our example of a 30–year $100,000 loan at 10%, $80,000 could be subject to six months' interest, or $4,000.

- **Low Equity** – An owner who somewhat recently financed the purchase of a home with a low down-payment PMI loan probably has not built up enough equity to make refinancing reasonable unless the home has undergone enormous appreciation as a result of unusual demand influences.

- **Assumability** – FHA–insured and VA–guaranteed assumable loans, if written at favorable interest rates, should not be refinanced. On the other hand, old high–interest rate FHA and VA loans should be refinanced for lower rates.

COSTS OF REFINANCING

ORIGINATION FEE

- **Points** – Most lenders increase their yields on mortgage loans by charging loan origination fees described as “points.” One “point” is one percent of the face amount of the loan For refinancing loans, these points are deductible for federal income tax purposes only over the life of the loan. A one point fee on our $100,000 loan would be $1,000.

- **Insurance** – For VA–guaranteed, FHA–insured or PMI insured loans there will be either a servicing fee or an insurance fee to guarantee or insure the lender against loss in the event of default.

- **Application Fee** – Many lenders will require an initial application fee which may include an appraisal fee. These fees may not be refundable even if the lender declines the loan. All the details about the loan should be learned by the prospective borrower *before* submitting an application with a loan fee to a lender.

- **Credit Report** – Nearly all lenders pass along to prospective borrowers not only the actual cost of a credit report, but also a fee for processing and evaluating.

- **Title Insurance** – Most lenders will require a new ALTA extended coverage policy of tide insurance to insure the lender's interest in the property. The premium for a policy issued by the same company which issued the previous lender's policy may be negotiated at a lower or discounted rate.

- **Attorney Fees** – Some lenders pass along to borrowers a fee to cover the lender's attorney fees which may be encountered in connection with administering the loan.

- **Prepaid Interest** – If a loan escrow is to close in the middle of a month, say July 16, and the first mortgage payment is to be due on September 1, the end of the first full month following closing, the lender is likely to want a prepaid interest payment for the period from July 16 through July 31. Then the first mortgage payment on September 1 will include exactly one month's interest, and the payment will be a part of the **"**level payment plan**"**–the same monthly payment for the life of the loan, or until the interest rate is adjusted in the case of an ARM.

- **Warehousing Fee** – Some lenders charge a warehousing fee for holding the loan until it can be sold in the secondary money market.

- **Tax Service** – Some lenders charge a tax service fee to subscribe to services that keep lenders informed about delinquent property taxes.

THE HOME EQUITY LOAN OR LINE OF CREDIT

THE SECOND MORTGAGE

The second mortgage loan has been the source of financing of many kinds of projects for generations. Many homeowners in the past have obtained second mortgage loans on their homes to obtain funds for business ventures or investments. When those investments were successful, the second mortgage turned out to be a good idea. When those ventures were unsuccessful, the second mortgage often caused the loss of the home. Clearly, the second mortgage on the home puts the home at risk. Nevertheless it has always been a ripe source of financing for many purposes.

- **Home Improvements** – The second mortgage loan has been the most common source of financing for home improvement projects. Congress recognized this importance in the creation of the FHA mortgage insurance plan in 1934. FHA Title I loans were authorized with FHA insurance for home improvement loans.

Line of Credit

The home equity line of credit is a recent variant on the second mortgage, created largely as a result of changes in the tax laws.

Tax Law Changes

- **The Tax Reform Act of 1986** – Congress changed the rules about the deductibility of interest, beginning with the 1987 tax year. The deductibility of home mortgage interest was retained, although some limitations were established. In the 1987 law changes, first applicable in the 1988 tax year, the present rules for deductibility of home mortgage interest were established.

- **Deductibility** – Home mortgage interest is deductible, with limitations, on first and second mortgages (including home equity lines of credit) on first and second homes, up to the following limits:

  - Home acquisition indebtedness, up to $1 million. Original home acquisition indebtedness can be increased by home improvement financing but cannot be increased by simply refinancing.

  - Home equity indebtedness, up to $100,000.

- **Consumer Interest** – while home mortgage interest remains essentially deductible, consumer interest deductibility has been phased out after 1990.

- **The Lure to Home Loans** – Instead of consumer financing, an automobile loan, for example, why not finance the purchase of a new automobile with a home equity loan, so that all of the interest will be deductible? The institutional lenders were quick to recognize this rich source of new business, the home equity line of credit – money for any purpose, with full deductibility of interest, up to the limits on home mortgage interest deductibility.

HOME EQUITY LOAN CONSUMER PROTECTION ACT

This new law, effective 1989, requires lenders who offer home equity lines of credit to meet much more detailed requirements or face stiff penalties.

- **New Disclosures** – Each lender must give to a home equity loan applicant a copy of the Federal Reserve Board's new consumer education brochure, and a sample 15–year chart of a $10,000 line of credit tied to a prime–rate index and with a 2% margin. Although the start rate of a new loan seems attractive to the borrower, the 15–year history shows how the loan could have changed in the past and might change in the future.

- **Prohibitions** – Unilateral changes in the terms of existing lines of credit are now prohibited. Indexes selected must not be within the control of the lender.

- **Advertising** – If ***"teaser rates"*** are offered, the annual percentage rate (APR) must be disclosed.

WHEN YOUR HOME IS ON THE LINE

The ease of mortgaging one's home to finance consumer spending can lead to excesses which jeopardize the security of the home. To help warn consumers about this danger, The Board of Governors of the Federal Reserve System has published the booklet **"When Your Home is on the Line: What You Should Know About Home Equity Lines of Credit."** The following is quoted from that booklet.

WHAT YOU SHOULD KNOW ABOUT HOME EQUITY LINES OF CREDIT

More and more lenders are offering home equity lines of credit. By using the equity in your home, you may qualify for a sizable amount of credit, available for use when and how you please, at an interest rate that is relatively low. Furthermore, under the tax law–depending on your specific Situation – you may be allowed to deduct the interest because the debt is secured by your home.

If you are in the market for credit, a home equity plan may be right for you or perhaps another form of credit would be better. Before making this decision, you should weigh carefully the costs of a home equity line against the benefits. Shop for the credit terms that best meet your borrowing needs without posing undue financial risk. And, remember, failure to repay the loan could mean the loss of your home.

WHAT IS A HOME EQUITY LINE OF CREDIT?

A home equity line is a form of revolving credit in which your home serves as collateral. Because the home is likely to be a consumer's largest asset, many homeowners use their credit lines only for major items such as education, home improvements, or medical bills and not for day–to–day expenses.

With a home equity line, you will be approved for a specific amount of credit–your credit limit – meaning the maximum amount you can borrow at any one time while you have the plan.

Many lenders set the credit limit on a home equity line by taking a percentage (usually 75 percent) of the appraised value of the home and subtracting the balance owed on the existing mortgage.

☞ ***Example:***

Appraisal of home$400,000
LTV 75%
Percentage of appraised value$300,000
Less mortgage debt– $250,000
Potential credit line$50,000

In determining your actual credit line, the lender also will consider your ability to repay, by looking at your income, debts, and other financial obligations, as well as your credit history.

Home equity plans often set a fixed time during which you can borrow money, such as 10 years. When this period is up, the plan may allow you to renew the credit line. But in a plan that does not allow renewals, you will not be able to borrow additional money once the time has expired. Some plans may call for payment in full of any outstanding balance. Others may permit you to repay over a fixed time, for example 10 years.

Once approved for the home equity plan, usually you will be able to borrow up to your credit limit whenever you want. Typically, you will be able to draw on your me by using special checks.

Under some plans, borrowers can use a credit card or other means to borrow money and make purchases using the line. However, there may be limitations on how you use the line. Some plans may require you to borrow a minimum amount each time you draw on the line (for example, $300) and to keep a minimum amount outstanding. Some lenders also may require that you take an initial advance when you first set up the line.

What should you look for when shopping for a plan?

If you decide to apply for a home equity line, look for the plan that best meets your particular needs. Look carefully at the credit agreement and examine the terms and conditions of various plans, including the annual percentage rate (APR) and the costs you'll pay to establish the plan. The disclosed APR will not reflect the closing costs and other fees and charges, so you'll need to compare these costs, as well as the APRs, among lenders.

Interest Rate Charges and Plan Features – Home equity plans typically involve variable interest rates rather than fixed rates. A variable rate must be based on a publicly available index (such as the prime rate published in some major daily newspapers or a U.S. Treasury bill rate); the interest rate will change, mirroring fluctuations in the index. To figure the interest rate that you will pay, most lenders add a margin, such as 2 percentage points, to the index value. Because the cost of borrowing is tied directly to the index rate, it is important to find out what index and margin each lender uses, how often the index changes, and how high it has risen in the past.

Sometimes lenders advertise a temporarily discounted rate for home equity lines–a rate that is unusually low and often lasts only for an introductory period, such as six months.

Variable rate plans secured by a dwelling must have a ceiling (or cap) on how high your interest rate can climb over the life of the plan. Some variable–rate plans limit how much your payment may increase, and also how low your interest rate may fall if interest rates drop.

Some lenders may permit you to convert a variable rate to a fixed interest rate during the life of the plan, or to convert all or a portion of your line to a fixed–term installment loan.

Agreements generally will permit the lender to freeze or reduce your credit line under certain circumstances. For example, some variable–rate plans may not allow you to get additional funds during any period the interest rate reaches the cap.

Costs to Obtain a Home Equity Line

Many of the costs in setting up a home equity line of credit are similar to those you pay when you buy a home. For example:

- A fee for a property appraisal, which estimates the value of your home.
- An application fee, which may not be refundable if you are turned down for credit.
- Upfront charges, such as one or more points (***one point equals one percent of the credit limit***).
- Other closing costs, which include fees for attorneys, title search, mortgage preparation and filing, property and title insurance, as well as taxes.
- Certain fees during the plan. For example, some plans impose yearly membership or maintenance fees.
- You also may be charged a transaction fee every time you draw on the credit line.

You could find yourself paying hundreds of dollars to establish the plan. If you were to draw only a small amount against your credit line, those charges and closing costs would substantially increase the cost for the funds borrowed. On the other hand, the lenders risk is lower than for other forms of credit because your home serves as collateral. Thus, annual percentage rates for home equity lines are generally lower than rates for other types of credit. The interest you save could offset the initial costs of obtaining the line. In addition, some lenders may waive a portion or all of the closing costs.

HOW WILL YOU REPAY YOUR HOME EQUITY PLAN?

Before entering into a plan, consider how you will pay back any money you might borrow. Some plans set minimum payments that cover a portion of the principal (the amount you borrow) plus accrued interest. But, unlike the typical installment ban, the portion that goes toward principal may not be enough to repay the debt by the end of the term. Other plans may allow payments of interest alone during the life of the plan, which means that you pay nothing toward the principal. If you borrow $10,000, you will owe that entire sum when the plan ends.

Regardless of the minimum payment required, you can pay more than the minimum and many lenders may give you a choice of payment options. Consumers often will choose to pay down the principal regularly as they do with other loans. For example, if you use your line to buy a boat, you may want to pay it off as you would atypical boat loan.

Whatever your payment arrangements during the life of the plan – whether you pay some, a little, or none of the principal amount of the loan – when the plan ends you may have to pay the entire balance owed, all at once. You must be prepared to make this balloon payment by refinancing it with the lender, by obtaining a loan from another lender, or by some other means. If you are unable to make the balloon payment, you could lose your home.

With a variable rate, your monthly payments may change. Assume, for example, that you borrow $10,000 under a plan that calls for interest–only payments. At a 10 percent interest rate, your initial payments would be $83 monthly. If the rate should rise over time to 15 percent, your payments will increase to $125 per month. Even with payments that cover interest plus some portion of the principal, there could be a similar increase in your monthly payment, unless the agreement calls for keeping payments level throughout the plan.

When you sell your home, you probably will be required to pay off your home equity line in full. If you are likely to sell your house in the near future, consider whether it makes sense to pay the up–front costs of setting up an equity credit line. Also keep in mind that leasing your home may be prohibited under the terms of your home equity agreement.

COMPARING A LINE OF CREDIT AND A TRADITIONAL SECOND MORTGAGE LOAN

If you are thinking about a home equity line of credit you also might want to consider a more traditional second mortgage loan. This type of loan provides you with a fixed amount of money repayable over a fixed period. Usually the payment schedule calls for equal payments that will pay off the entire loan within that time. You might consider a traditional second mortgage loan instead of a home equity line if, for example, you need a set amount for a specific purpose, such as an addition to your home.

In dealing which type of loan best suits your needs, consider the costs under the two alternatives. Look at the APR and other charges. You cannot, however, simply compare the APR for a traditional mortgage loan with the APR for a home equity line because the APRs are figured differently.

- The APR for a traditional mortgage takes into account the interest rate charged plus points and other finance charges.
- The APR for a home equity line is based on the periodic interest rate alone. It does not include points or other charges.

Disclosures from Lenders – The Truth in Lending Act requires lenders to disclose the important terms and costs of their home equity plans including the APR, miscellaneous charges, the payment terms and information about any variable–rate feature. If you have not received this information from the lender, any application fees you have been charged must be refunded. You usually get these disclosures when you receive an application form, and you should get additional disclosures before the plan is opened. If any term has changed before the plan is opened (other than a variable–rate feature), the lender must return all fees if you decide not to enter into the plan because of the changed term.

When you open a home equity line, the transaction puts your home at risk. The Truth in Lending Act gives you three days from the day the account was opened to cancel the credit line. This right allows you to change your mind for any reason. You simply inform the creditor in writing within the three–day period. The creditor must then cancel the security interest in your home and return all fees – including any application and appraisal fees paid in opening the account.

SHOPPING FOR THE LOAN

HOW TO SELECT A LENDER?

One of the important decisions that a borrower will make in the loan process is to select the right loan broker to handle the finance portion of his or her transaction. Equally important is making sure that the mortgage broker knows which loan programs to recommend to his or her clients. As many as 50 to 200 different lenders are available to each loan broker. However; most brokers concentrate on 5 to 10 specific lenders and work with only those loan pro–grams that these few lenders offer. The broker works on a regular basis with relatively few lenders and knows their programs well. Yet these limited offerings may not give consumers the best possible choices. Lenders typically specialize in only a limited number of programs. If the borrower fits into one of these loan packages well, both the lender and borrower benefit. However, if the borrower is mismatched with a loan that does not best fit his or her needs, the relationship is not good from the initial loan closing.

A mortgage loan broker receives rate sheets from lenders on a regular basis or upon request. The broker should begin with the lenders with which they regularly deal. Ask for ALL the loan programs that these particular lenders typically fund. Then call other lenders and ask about their loan programs, to gain a broader range of loan types available for your clients. Not every lender handles every type of loan. A borrower may fit a particular program perfectly, but it may require the mortgage loan broker to do some extra work to find a lender who knows of the program or who handles a particular type of loan. Other criteria to review on selecting a lender with the various loan types include:

- What is the lender's ability to lock in an interest rate?
- What date or event will the loan rate tie to: application date, funding date, advertised rate?
- What loan points, fees, and costs go with which kind of loan?
- Will the lender give you references of other loan brokers who use this lender?
- What is the average time to close the loan once a processed loan is submitted?
- What loan terms and programs are available to the loan broker?
- What underwriting guidelines does the lender prefer for the loan package?

In addition to how the mortgage broker selects a type of loan and the criteria for selecting a lender, it should be noted that not all loans are available. Investors enact many different loan programs, but lenders may choose not to offer a particular loan program. Lenders become familiar with certain loan programs in light of meeting the loan program criteria and upon reviewing the foreclosure or slow–payment record on the performance of a particular loan. Thus the mortgage loan broker should check with several lenders in advance as to' the availability of a particular loan program.

The primary consideration for selecting one conventional lender over another is often not the interest rate, fees, or programs that are available. The main criterion is often the quality of service provided by the lender. This is where an ongoing relationship can be most helpful to the mortgage loan broker. The following list may be helpful in considering the lender with which to establish a regular working relationship:

- Does the lender offer lock–in loan commitments? For what time period?
- What is the typical processing and underwriting time?

- Can you call regularly to check on the status of your loan and receive a friendly response?

INSTITUTIONAL

The great majority of real estate loans are made by a group of financial institutions referred to as "Institutional lenders" or "financial intermediaries." They provide the principal source of funds for mortgage lending. Lending institutions such as commercial banks, savings and loan associations, insurance companies, credit unions, and investment companies are financial intermediaries, economic units whose principal function is to transfer capital from those who invest funds to those who wish to borrow. This service is called "intermediation."

- **Policies** – In this role of middleman, the financial intermediary pools funds from many sources (individual savers or other short–term or long–term investors) and converts them into loans suitable to the needs of individual borrowers. By focusing on particular markets (investment funds to purchase housing, for example) the intermediary acquires special competence in a specific field and is able to pass on cost savings and other benefits to investor and borrower alike.

- **Advantages/Disadvantages** – The "loan officers" of these institutions provide valuable services to prospective borrowers and to real estate brokers and their customers. Each loan officer, however, is marketing the loan programs of that one institution and may be promoting programs designed to meet that institution's needs in a constantly changing money market. Another advantage is that an institution may give preferential treatment to its regular customers.

MORTGAGE COMPANIES

- **Mortgage companies, or mortgage bankers**, make mortgage loans and sell them to investors. They "originate, finance, and close first mortgage loans secured by real estate and sell such loans to Institutional investors for whom the loans are serviced under a contractual relationship."

- **Loan Correspondents** – Mortgage companies operate primarily as mortgage loan correspondents of life insurance companies, mutual savings banks, pension funds, and other financial institutions. They may furnish mortgage loans to these institutions which are located in only one local area, one state, or in several states. The mortgage companies, with their loan brokerage functions, are one of the prime sources for mortgage loans on homes, on income property, and under FHA and DVA programs are the largest originators of government insured or guaranteed loans to moderate income groups.

- **Source of Funds** – Many mortgage companies have sizable funds of their own and are consistent lending sources in the mortgage market and also engage in additional business operations such as property rentals, leases, management of properties, and insurance and operate as real estate brokers. Many obtain their funds from commercial banks on short–term borrowing by obtaining lines of credit and by arranging for advances from banks against mortgage documents while such loans are in process of being sold to the ultimate purchaser of the paper.

- **Regulation** – These companies are subject to minimum supervision and have wide latitude of powers. The companies are usually free of lending limitations such as are placed on Institutional lenders and, except for inspections by an examiner in conformity with state laws, assume entire responsibility and make all decisions about their mortgage lending operations and their servicing of these loans.

- **Secondary Market Activities** – Some companies serve only as intermediaries and resell the loans as soon as they are made, under such programs as Federal National Mortgage Association, Government National Mortgage Association and Federal Home loan Mortgage Corporation, all secondary market facilities.

- **Business Activities** – The mortgage banker is often an "importer" of funds, acting as an intermediary between out–of–state or distant investors and local borrowers, causing funds in capital–surplus areas to be transferred to capital – deficient areas such as California.

- **Lending Policies** – The prevailing policy of these mortgage companies is to deal in mortgages which are most readily salable in the secondary market. Therefore these "temporary" lenders prefer government–insured or government–guaranteed mortgages, and conventional or uninsured mortgages for which they have advance purchase commitments. Generally mortgage bankers restrict their conventional loans to selected residential and business risks, and to loans in price ranges suitable to the needs of investment fins that comprise the secondary mortgage market.

- **Application Procedure** – The mortgage banker acts as a liaison or middleman between the borrower and the lender. when a borrower seeks a loan from a mortgage banker the usual procedures are:

  - The customer fills out a loan application, assisted by a loan officer;
  - A credit report is ordered;
  - A company appraiser evaluates the property (at this stage the investor, usually an Institutional buyer, has been determined, and the appraiser is guided by standards important to the investor, e.g., new homes only);
  - The application package, including application form, borrower's financial statement, appraisal, photographs of the property, and a copy of the sale agreement or building contract is mailed to the investor;
  - The investor decides whether to accept;
  - Approval is sent to the mortgage company;
  - When specific loan conditions are met, the mortgage banker forwards funds to escrow for closing; and,
  - After closing, the key documents are sold to the investor, and the mortgage banker is ready to commence servicing the loan.

- **Advantages/Disadvantages** – The mortgage loan broker can offer to the prospective borrower a much more extensive menu of loans of many types from many lenders. The borrower can effectively "shop" more extensively for the most advantageous loan and most suitable loan from the borrower's point of view. However, a loan broker must be paid a brokerage fee for the services rendered. This fee is negotiable, and may be paid by the lender from the loan origination fee or discount points.

PORTFOLIO LENDERS

Lenders who make some loans which they do not intend to sell in the secondary mortgage money market are referred to as "portfolio lenders." These loans do not have to meet FNMA/FHLMC guidelines. For these loans, a lender may accept credit problems and may make higher risk loans at higher interest rates.

WHAT KIND OF LOAN?

Total price of a property seems to be of much less consequence to buyers than purchase terms. They shop terms. If the down-payment and monthly payments are low enough to meet their "pocketbook," price appears to be of secondary importance. The same is true in shopping for a loan.

- **Fixed Rate or Adjustable Rate** – If the borrower has sufficient income and credit position to qualify for either a *fixed* rate or an adjustable rate loan, which would be better for the borrower? Here the borrower does his own gambling. if the borrower thinks that interest rates will go up, a fixed rate loan will provide protection from rising interest rates. if the borrower expects interest rates to fall, an adjustable–rate loan will provide interest savings.

- **Shopping for an ARM** – Because the adjustable–rate loan requires that the borrower assume the risk that interest rates might rise, the borrower should expect a lower interest rate, not counting the initial "teaser" interest rate that applies only for the first few months. To make comparisons, look at the APRs, not just the interest rates.

    - **Shop Indexes** – The "cost of funds" index is the slowest changing–preferable if interest rates are lower at the time but might go up. The U.S. Treasury bill index is the fastest changing–preferable if interest rates are high at the time but are expected to go down.

    - **Shop Margins** – The margin is the percentage added to the index to arrive at the applicable interest rate of the loan after the initial "teaser" rate is terminated at the first adjustment period. Margins can be 2%, 2.5%, 3%, etc. A high margin with a low index could be preferable to a low margin with a high index, or vice versa.

    - **Shop Caps** – Some ARMs provide annual interest rate caps – the maximum annual interest rate increase, example 2%; and some ARMs provide lifetime interest rate caps, example five percent. Some ARMs have payment caps, for example 7}% maximum annual increase in the payment, regardless of interest rate increases.

GOVERNMENT LOANS

FHA and DVA loans – The emergence of FHA–insured and DVA–guaranteed home loans had a tremendous influence upon the changing pattern of demand for loan funds and home loan practices. Historically they have offered the borrower a lower rate of interest, highest ratio of loan to appraised value and longest maturity. However, since December 1, 1983, HUD no longer controls FHA–backed interest rates; they are free to float to market rates. DVA–backed mortgages still have interest rates controlled by the DVA Administrator. With the exception of new tract sales, usually more paper work is involved in obtaining government–backed loans and more time is consumed in their processing. In periods of tight money they may be almost unobtainable or certainly available only if the seller is willing to discount at an extremely high rate.

CONVENTIONAL LOANS

Where the borrower has a substantial down payment and time is important, conventional loans offer advantages even though the maturities may be shorter and payments and interest rates may be higher, especially when a fixed–rate mortgage is sought. These loans usually have shorter processing time, more flexible terms, can be had on a wider variety of properties, and, overall, cost the borrower less in total interest payments. Laws affecting the ratio of loan to value vary among the different conventional lenders or financial institutions.

SELECTION OF A CONVENTIONAL LENDER

The selection of a proper conventional lender for a client is an involved process and should be done with great care. A real estate salesperson should look at all of the conventional lenders and not just at the interest rate. The salesperson who selects a lender based only on the interest rate may be doing a disservice to his or her client.

Also, the policies of a conventional lender can change from time to time. One reason for this change may be that the lender has a commitment from a different investor and the underwriting guidelines of that investor are different, thus the lender must change its policies. So it is important, then, for you to check the conventional market on a continuing basis, for what was true last week may not be true this week.

When dealing with the conventional mortgage, one thing must be kept in mind: because a client is rejected by one conventional lender does not mean that the client will be rejected by all of the conventional lenders. Each lender has its own set of rules for accepting or rejecting a loan application. This is not true for VA or FHA loans. If either the VA or the FHA rejects the application, there is usually little hope of getting the application approved by the other.

In order to compare lenders, you have to know what items to look for. Here are some of the main items to check out and compare:

- **Interest rate** – The interest rate is the one item that immediately comes to mind when discussing differences between lenders. Interest rates frequently change for such reasons as demand, supply, risk, competition, and so on. There is no set pattern as to how often interest rates can change. They can change weekly or even daily. Interest rates also vary according to the type of property and loan–to–value ratio. For example, a 95% loan may command a higher rate than an 80% loan because of the higher risk.

5. **Loan fees** – The fee charged on loans is another item that each lender must determine. Loan fees on an 80% loan typically vary from 0 to 2% of the loan amount. Higher loan–to–value ratio loans (90 to 95 percent) carry higher loan fees. Most lenders offer tiered pricing, with points increasing as interest rates decrease. For instance, if borrowers want to secure a 7% rate, they may pay two points, while the points–sensitive borrower may pay zero points but accept an 8 to 9% interest rate. The type of property may also affect the loan fee. For example, a lender may decide to charge a higher loan fee on three– to four–unit dwellings as opposed to an owner–occupied single–family home.

- **Loan–to–value ratio** – Conventional lenders are able to make loans up to 95 percent, and in special cases 97% on one–to–four–unit properties. As a matter of policy, many lenders lower their loan–to–value ratios on three– and four–unit properties, non–owner–occupied properties, land loans, and refinance loans. In some cases, conventional lenders will make 100 to 125% loans, but these are not considered “standard loans” and often carry excessive loan fees.

3. **Maximum loan amounts** – Each lender sets its maximum loan amount. The loan amounts vary by type of property. For owner–occupied residential properties of one to four units, many lenders use the Fannie Mae/Freddie Mac loan maximums discussed in Chapter 7. These are “conforming” loans, based on the lenders' ability to sell the loans to

FNMA/FHLMC, which set maximum loan limits. These loan limits change each year, and a borrower should call a loan officer or mortgage broker to determine the current limits. Other conventional lenders specialize in jumbo loans (loans greater than the Fannie Mae and Freddie Mac limits) for higher–priced homes.

6. **Prepayment penalties** – As already noted, most conventional lenders are no longer charging prepayment penalties. When they do, the typical prepayment penalty on a conventional loan is six months' interest on the amount prepaid that exceeds 20% of the original amount of the loan. However, penalties vary with the lender. They can even be eliminated in some cases. For example, a lender may waive the prepayment penalty if the seller has the new buyer finance the purchase with the same lender.

   Finally, there is no reason to charge penalties to pay off an adjustable rate mortgage (ARM), since the rate varies with the interest rate market so that the lender need not be burdened with finding productive use of loans that are prematurely repaid. (In the past, lenders paid off on high–interest loans in a low–interest environment charged penalties to offset some of the interest losses and loan origination costs.) Under California law, prepayment penalties cannot be imposed beyond 5 years.

7. **Borrower qualifications** – There is no standard way to qualify a borrower, and each lender determines its own standards. Some lenders are very strict in qualifying a borrower, while others may be more lenient. Many conventional lenders use the Fannie Mae/Freddie Mac guidelines.

- **Types of loans** – A few conventional lenders make only fixed rate loans. Other lenders offer adjustable rate loans, on which the interest rate is subject to change according to a specified index. Adjustable rate loans, for example, have been used since 1923 by the California Department of Veterans Affairs. Other types of Loans are also available, such as convertible rate, buy–down loans, and, in some cases, reverse mortgages.

2. **Type of property** – Lender policy determines the type and quality of property the lender is willing to accept as security for the loan. Does it lend on one– to four–unit properties only, or does it lend on larger apartment houses, and commercial and industrial property? Will the lender make a loan on a steep hillside lot?

   Some lenders do not, because of the slide risk. There are other property standards that a lender sets, and these standards can vary greatly from one lender to the next, as long as they are not illegally discriminatory.

Policies and standards set by conventional lenders are not static. A conventional lender can change its property and borrower standards the same way it changes the interest rate. These changes are made to accomplish certain goals. If a lender has a surplus of money, it has to find a way to make more loans. It may lower its property or borrower standards. Or it can lower the interest rate or change some other policy that will enable it to make more loans. If the conventional lender wants to reduce loan demand, it could tighten up on its standards and increase the interest rate and loan fees, but its policies and standards cannot be discriminatory under fair housing laws.

QUESTIONS FOR THE BORROWER TO ASK

LENDER'S QUESTIONS

A lender asks a prospective borrower many questions before making a commitment to make a loan. The answers are submitted as a part of the loan application, usually along with an application fee which may include charges for a property appraisal and a credit report. This application fee is usually not refundable, even if the lender declines to make the loan. The loan application is not designed for persons merely inquiring about real estate loans who have yet to reach a decision to buy or finance. It is for the person who presumably will follow through and borrow, providing a loan is approved by the lender.

☞ ***Many loan applications to many lenders is not an effective way to "shop" for a loan.***

BORROWER'S QUESTIONS

The following is a check list of questions for the borrower to ask before making a formal loan application and paying an application fee to the lender.

- **Borrower's Decision** – The prospective borrower will not always get satisfying answers to all of the questions asked, but by comparing the answers of several lenders the prospective borrower has the information needed to make informed decisions about a loan application.

- **Borrower's Checklist** – (Questions to ask before making a loan application and paying an application fee to a lender)

  - Fixed–rate APR?
  - Adjustable–rate APR?
  - Index used?
  - Margin?
  - Frequency of rate adjustments?
  - Loan origination fee?
  - Is the origination fee negotiable?
  - Discount points?
  - Are the discount points negotiable?
  - Credit report fee?
  - Appraisal fee?
  - Other closing costs?
  - Loan application fee? II What does the application fee cover?
  - Balloon payments?
  - Can interest rates be locked in? At what cost?
  - What are the lender's qualifying ratios?
  - Will the lender accept a CLTA title insurance policy?
  - Assumability? Under what terms?
  - Prepayment penalties?

CHAPTER QUIZ

1. Replacing an existing loan with a new one is called:

   A. Assumption
   B. "Subject to"
   C. Refinancing
   D. Prequalifying

2. Common reasons for refinancing include:

   A. Paying off a balloon payment
   B. Getting a lower interest rate
   C. Turning equity into tax–free income
   D. All of the above

3. As a general rule, it pays to refinance when the new interest rate will be at least _ __ % lower and the costs will be recaptured from lower monthly payments within ___ months:

   A. 5, 24
   B. 2, 36
   C. 2, 24
   D. 1, 36

4. Costs of refinancing commonly include:

   A. New title insurance policy
   B. Application fee
   C. Points
   D. All of the above

5. The home equity loan or line of credit is a form

   A. Second mortgage
   B. Consumer loan
   C. Unsecured loan
   D. Home acquisition indebtedness

6. Refinancing can enhance the salability of a property:

   A. With a large new assumable loan on good terms
   B. Only for a speculative investor
   C. By getting an ARM with a low teaser rate
   D. Almost never

7. Reasons not to refinance include:

   A. Good existing terms
   B. Prepayment penalties
   C. Little increase in equity since previous financing
   D. All of the above

8. The home equity loan or line of credit originated because of:

   A. Increasing scarcity of consumer credit
   B. New federal rules on deductibility of interest
   C. Problems with foreclosures on balloon payments
   D. Widespread fear of refinancing

9. The maximum amount of a home equity line of credit is usually:

   A. The appraised value of the home
   B. 75% of the appraised value of the home
   C. 75% of the appraised value of the home, less existing mortgage debt
   D. $100,000

10. For a home equity loan or line of credit, the Truth in Lending law:

   A. Does not apply
   B. Provides a three–day right to cancel
   C. Requires disclosure of APR, payment terms, and variable–rate features
   D. Both B and C

Answer Key: 1–C, 2–D, 3–B, 4–D, 5–A, 6–A, 7–D, 8–B, 9–C, 10–D

CHAPTER 16: APPENDICES

APPENDIX A: ADDITIONAL INTERNET RESOURCES

www.mortgageinfocenter.com	(Mortgage strategies)
www.imoneynet. com	Interest rating rates
www.bankrate.com	Interest rating rates
www.iloans.com	Amortization schedules, closing costs
www.amo–mortgage.com	Refi, debt consolidation, Mortgage
www.homepath.com	Loan brokerage
www.fanniemaefoundation org	Fannie Mae
www.countrywide.com	Loan brokerage – Countrywide)
www.eloan.com	Loan brokerage
www.iown.com	Loan brokerage
www.thirdage.com/realestate	(links)
www.mortgagecalc.com	Affordability)
www. Mortgage101.com	Down loadable forms, etc.
www.seniorsites.com	Non profit housing for seniors
www.inman.com/summit	In man News Features
www.reprofile.com	Stewart Title
www.kiplinger.com	Buying/Selling home
www.recyber.com	R. E. Cyberspace Society
www.quickenmortgage.com	Loan brokerage,
www.mortgagemart.com	Information on mortgage lending, banking, etc.)
www.homegain.com	Home Gain
www.ditech.com	Loan brokerage
www.imoneynet.com	Mortgage Borrowing
www. homeadvisor.msn.com	
www. msn.com	
www. keystroke.com	Loan brokerage
www. mortgagemag.com	Loan brokerage
www. Lendingtree.com	Loan brokerage
www. mortgagelocator.com	Loan brokerage
www.mortgagel101.com	(Step–by–step guides
www.easierhomeloans.com	Home buying essentials: loan application, rates, credit considerations
www.hud.gov	
www.hrblock.com	Tax service and consulting firm
www.realestate.com	loan auctions (Borrower posts criteria and

	lenders bid for the loan)]
www.onerealtorplace.com	Media and consumers
www.thinkglink.com	Real estate and personal financial reporter
www.verticallend.com	Loan brokerage
www.pricelinemortgage.com	Loan brokerage
www.virtumendo.com	Loan brokerage
www.foreclosurefreesearch.com	Foreclosures, bank and government–owned real estate. ...
www.insurance.ca.gov	Regulations for insurance companies, and insurance licensees
www.arri–assoications.org	American Society of Farm managers and Rural Appraisers
www.appraisalinstitute.org	Appraisal Institute
www.aicanada.org	Appraisal Institute of Canada
www.orea.ca.gov	California Office of Real Estate Appraisers
www.frea.com	Foundation of Real Estate Appraisers
www.nahb.com	National Association of Home Builders
www.naifa.com	National Association of Independent Fee Appraisers
www.iami.org/narea.html	National Association of Real Estate Appraisers
www.appraisalfoundation.org	The Appraisal Foundation

APPENDIX B: CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES

Due to the volume of this handbook, we are unable to include it inside the text book. However, it is available inside the CD media attached with your book.

Or you may download it directly from the below web link:

☞ ***www.federalreserve.gov/pubs/brochures/arms/arms.pdf***

APPENDIX C: HUD'S HOMEBUYER'S GUIDE

Due to the volume of this handbook, we are unable to include it inside the text book. However, it is available inside the CD media attached with your book.

Or you may download it directly from the below web link:

www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/preface.pdf
www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/chapter1.pd
www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/chapter2.pd
www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/chapter3.pd
www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/chapter4.pd
www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/chatper5.pd
www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/chapter6.pd
www.fanniemae.com/global/pdf/housingcommdev/resourceshomeed/glossary.pd
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