20 Hour SAFE Comprehensive: Financing Residential Real Estate

COURSE MANUAL
Part 1

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4/24

20 Hour SAFE Comprehensive:
Financing Residential Real Estate

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Rules of Conduct for NMLS Approved Pre-Licensure (PE) and Continuing Education (CE) Courses

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The Secure and Fair Enforcement for Mortgage Licensing Act (SAFE ACT) requires that state-licensed MLO's complete pre-licensing (PE) and continuing education (CE) courses as a condition to be licensed. The SAFE Act also requires that all education completed as a condition for state licensure be NMLS approved. Since 2009 NMLS has established course design, approval, and delivery standards which NMLS approved course providers are required to meet. To further ensure students meet the education requirements of the SAFE Act, NMLS has established Rules of Conduct (ROC). The ROC, which have been approved by the NMLS Mortgage Testing & Education Board, and the NMLS Policy Committee, both of which are comprised of state regulators, are intended to stress that NMLS approved education be delivered and completed with integrity.

Rules of Conduct

NMLS approved course providers are not authorized by NMLS to grant exceptions to these rules and that I alone am responsible for my conduct under these rules. I also understand these rules are in addition to whatever applicable rules the course provider may have set.

Additionally, I understand that the course provider or others may report any alleged violations to NMLS. NMLS may conduct an investigation into alleged violations and may report alleged violations to the state(s) in which I am seeking licensure or maintain licenses, or to other states.

As an individual completing PE or CE I attest the course format I am being credit banked for has been entirely completed by myself alone and have met required below:

Classroom (live)

- Completed sign-in by providing my signature prior to the start of the course
    - Provided government issued ID at time of sign-in of the course to verify identity
- Engaged with other students and instructor(s)
- Returned from breaks and lunches on time as required
- Participated and was engaged throughout the entire course
- Properly completed the entire seat-time the SAFE Act required for the approved NMLS course in order to receive an end-of-course completion certificate

Classroom Equivalent (webinar)

- Provided at the time of entering the webinar platform:
    - Government issued ID
    - Knowledge-Based Authentication
- Returned from breaks and lunches on time as required

- Properly completed the entire seat-time the SAFE Act required for the approved NMLS course in order to receive an end-of-course completion certificate by the following means:
    - Provided adequate camera access to ensure visibility for the entire duration of the course by enabling the proctor to ensure I was visible from the shoulders up
- Understand that if I fail to maintain camera presence for a period of greater than 10 minutes I will be removed from the class and not receive credit
- Engaged and completed all course quizzes and case studies
- Engaged and completed all polls
- Understand at various times during the CEQ/webinar course, I will be required to authenticate my identity and engagement.
- Engaged with other students and facilitators/instructor(s)

Online Instructor-Led (online with instructor)

- Provided at the time of entering the Learning Management System (LMS):
    - Personal identification requirements set forth by the provider
- Have not and will not divulge my login ID or password or login credentials to another individual for any online course
- Used my own personal login information to complete the NMLS approved online course
- Properly completed the entire seat-time the SAFE Act required for the approved NMLS course in order to receive an end-of-course completion certificate by the following means:
- Engaged and completed all course quizzes and case studies
- Engaged with other students and facilitators/instructor(s)

Online Self-Study (online without instructor)

- Provided at the time of entering the Learning Management System (LMS):
    - Personal identification requirements set forth by the provider
    - Used and authenticated my own personal login for BioSig to enter and complete the NMLS approved online course
- Have not and will not divulge my login ID or password or login credentials to another individual for any online course
- Understand at various times during the online course, I will be required to authenticate my identity through a biometric system.
- Properly completed the entire seat-time the SAFE Act required for the approved NMLS course in order to receive an end-of-course completion certificate by the following means:
- Engaged with all the course content and completed all course quizzes and case studies

Additionally, I

1. Attest that I am the person who I say I am and that all my course registration information is accurate.

2. Acknowledge that I am required to show a current government issued form of identification prior to class entry and that the name on the identification matches the name as it appears on this course registration.

3. Understand that the SAFE Act and state laws require me to spend a specific amount of time in specific subject areas. Accordingly, I will not attempt to circumvent the requirements of any NMLS approved course. I will not use or attempt to use any artificial intelligence and/or large language model chatbots and/or other assistance to complete any NMLS approved course.

4. Will not give or attempt to give assistance to any other person who is registered to take an NMLS approved pre-licensure or continuing education course.

5. Understand that the course provider has the right to dismiss anyone from class that creates a disturbance or interferes with the administration of the course or other students' learning, including, but not limited to cell phone/smart watch usage.

6. Acknowledge that any outside activities are prohibited while attending class and grounds for immediate removal from class.

7. Will not engage in any conduct that would be contrary to good character or reputation or engage in any behavior that would cause the public to believe that I would not operate in the mortgage loan business lawfully, honestly or fairly.

8. Will not engage in any conduct that is dishonest, fraudulent, or would adversely impact the integrity of the course(s) I am completing or the conditions for which I am seeking licensure or renewal of licensure.

9. Understand and acknowledge my responsibility to report any violations or misconduct involving any of the above ROC to the (MTEB).

10. Understand the CSBS Privacy Notice is applicable to these Rules of Conduct. The CSBS Privacy Notice can be found here: https://www.csbs.org/privacy-policy

By signing below, I understand the Rules of Conduct listed above, and that any violations to these rules will be subject to an investigation by the state(s) in which I am seeking licensure in or maintaining licenses in. The results of any investigation may subject me to disciplinary actions by the state(s) or the State Regulatory Registry (SRR), including but not limited to:

- Revocation, suspension, or denial of license
- Disqualification from receiving class credit
- Retraction of class credit
- Fines
- Additional education

Print Name:________________________________ Course Number(s): _____________

Signature: _________________________________ Date (mm/dd/yyyy):_____________

Email: ____________________________________ NMLS ID# ____________________

Overview
- Mortgage Programs
- Government Loans
- Conventional/Non-Conforming
- Subprime Lending

In this lesson we will cover:
- Conforming and nonconforming loans
- Government loan programs
- Information on sub-prime lending
- Statement on Subprime lending
- Guidance on non-traditional product risk
  Mortgage Products
- Fixed Rate
- Adjustable Rate Mortgages (ARMs)
- Balloon/Reset Mortgages
- Reverse Mortgages
- Other Mortgage Products

Conventional/Conforming Mortgages

Loans made by lenders can be divided into two main categories:
- Conventional loans
- Government-sponsored loans

Conventional Loans
- Conventional loan - any institutional loan that isn't insured or guaranteed by a government agency
- *Most conventional loans comply with underwriting guidelines of Fannie Mae (FNMA) and Freddie Mac (FHLMC)*
- Conforming loan - complies with Fannie Mae/Freddie Mac guidelines.
- Non-conforming loan - does not comply with Fannie Mae/Freddie Mac guidelines.
- Majority of non-conforming loans are subprime loans

Conventional Loan Characteristics
- Lenders want to be able to sell their loans on secondary market. As a result, Fannie Mae and Freddie Mac's underwriting guidelines are widely followed and very influential in the mortgage industry

Conventional/Conforming Mortgages

Conventional loan may be secured by:
- Principal residence, (up to 4 dwelling units)
- Second home, (no more than 1 dwelling unit)
- Investment property, (borrower doesn't intend to occupy property)
- Allowed maximum properties financed
- FNMA will allow ownership interest in up to 10 properties with the following guidelines:
    - 25% down payment on the investment property
    - Minimum credit score of 720
    - No mortgage late pays w/in the last 12 months
    - No bankruptcies or foreclosures in the last 7 years

    - 2 years of tax returns showing rental income from all rental properties
    - 6 months of principal, interest, taxes, and insurance (PITI) reserves on each financed property

Loan Amounts – Conforming loan limits are set annually by Fannie Mae and Freddie Mac

- Agencies won't purchase loan if it exceeds limit
- Different loan limits for different parts of U.S.
- The conforming loan limits for 2024 changed from those placed in 2023. The baseline loan limits have increased in all, but two U.S. counties. The baseline one-unit property loan limit for 2024 is $766,550. In 2023 this figure was $726,200. The same is the case for the limit in high-cost areas. For places where 115% of local median values are higher than those of the baseline limit, the loan limits are higher. In high-cost areas The Housing and Economic Recovery mandates a ceiling from the baseline limit. This ceiling is set at 150%. For 2024, the high-cost area limit is set to $1,149,825.
- Jumbo loan - loan that exceeds conforming loan limits. Extra-large loans are sometimes called super jumbos
- About half of jumbo loans are Adjustable Rate Mortgages (ARMs).
- Higher interest rates

Conventional/Conforming Mortgages

Loan-to-Value Ratios

- Common conventional loan-to-value ratios (LTVs): 80%, 90%, and 95%
- Less common conventional LTVs: 97% and 100%
    - Conventional loans are often categorized by LTV ratio, with different underwriting rules applied to each category
    - High-LTV loans also have:
        - Higher interest rates and fees
        - Stricter underwriting rules
    - Fannie Mae and Freddie Mac require private mortgage insurance for any conventional loan purchased with LTV over 80%
        - At one time, Fannie Mae and Freddie Mac didn't buy ARM mortgages with LTVs over 90%
        - Now, both are willing to buy ARMs with LTVs up to 95% if certain conditions are met

Conventional/Conforming Mortgages

Private mortgage insurance (PMI) is designed to protect lenders from risk of high-LTV loans and makes up for reduced borrower equity.

Lenders generally allow secondary financing with some restrictions due to increased risk of default.

Examples of secondary financing restrictions:

- Borrower must qualify for payments on both first and second mortgages
- Borrower must make 5% down payment
- Scheduled payments must be due on regular basis
- Second mortgage can't require balloon payment less than 5 years after closing
- If first mortgage has variable payments, second mortgage must have fixed payments
- No negative amortization
- No prepayment penalty

Piggyback loan is another term for secondary financing and is used to either:

- Avoid paying private mortgage insurance.
- Avoid jumbo loan treatment.

Using secondary financing to avoid PMI can backfire if second loan has high interest rate and steep fees.

Bi-Weekly Payment Plan

- Mortgagor pays ½ normal payment every two weeks
    - 26 payments made annually
    - 13 payments a year instead of 12
    - Resulting in one extra payment a year
    - Equals an earlier payoff time

Government Loans

Lenders generally allow secondary financing with some restrictions due to increased risk of default.

Government Loans – FHA

Federal Housing Administration (FHA) was created in 1934 as part of National Housing Act to:

- Generate new jobs by increasing construction activity
- Stabilize mortgage market
- Promote financing, repair, improvement, and sale of real estate

Today, the FHA is part of Department of Housing and Urban Development (HUD)

- Primary function is insuring mortgage loans
- Compensates lenders for losses from borrower default
- Does not build homes or make loans

Mutual Mortgage Insurance Plan is FHA insurance program funded by premiums paid by FHA borrowers.

Direct endorsers - lenders authorized to handle entire underwriting process for FHA loans.

If FHA borrower defaults on loan:

- FHA reimburses lender for full amount of loss
- Borrower required to repay FHA

Government Loans - FHA

Distinguishing features of FHA loans:

- Less stringent qualifying standards.
- Borrowers with minimum decision credit score at or above 580 are eligible for maximum financing
    - 3.5% down payment
- Borrowers with minimum credit score between 500 and 579 – limited to 90% LTV
- Borrowers with minimum credit score of less than 500 are not eligible for FHA-insured mortgage financing
- Secondary financing restrictions.
- Maximum loan amounts set by local limits and by LTV rules
- Borrower must come up with min cash investment plus funds for
    - Closing costs
    - Discount points
    - Prepaids
- Mortgage insurance always required
- No pre-payment charges
- Property must be owner-occupied primary residence

Government Loans – Department of Veterans Affairs (VA)

The VA loan program was established to help veterans finance the purchase of their homes and offers many advantages over conventional financing.

VA-guaranteed loans are made by institutional lenders, but a portion of loan is guaranteed by Department of Veterans Affairs and protects lender against losses from default.

May be used for finance, purchase or construction of a one-to-four unit residences

- Does not guaranty investor loans
- Veteran must occupy home

Key characteristics of VA loans:

- No down payment required
- No maximum loan amount
- No maximum income limits
- Least stringent qualifying standards
- Can be fixed-rate or ARM loans
- No mortgage insurance required

- No maximum interest rate
- Lender may charge flat fee of no more than 1% for administrative costs
- No prepayment penalties
- Forbearance extended to veterans with financial difficulties
- Can be assumed by creditworthy buyer, veteran or non-veteran

Government Loans – United States Department of Agriculture (USDA) Rural Loans

Provides homeownership opportunities to rural Americans

- Includes home renovations
- Also programs for the elderly, disabled or low-income of multi-unit housing buildings

Highlights of USDA Loans:

- 100% Financing
- Broad location guidelines
- No mortgage insurance requirement
- No seller contribution limit
- 100% of closing costs can be gift
- Loan amount can include closing costs and repairs up to a/v

USDA Guaranteed Loans vs. USDA Direct Loans

- The USDA direct loan is designed for very low-income families which makes it difficult for them to qualify for a conventional mortgage financing while USDA guaranteed loans are designed for moderate income groups.
- To be eligible for a direct loan, applicants must make between 50-80 percent of the median income for their area, adjusted for household size. For USDA guarantees loans, borrowers can have an income up to 115% of the median income for the area.
- With USDA direct loans, the USDA is the lender while private lenders fund the mortgage with USDA guaranteed loans. The government secures these loans so that there are no risks involved for the lender.
- Both USDA direct and guaranteed loans require borrowers to have a satisfactory credit history and the ability to repay the mortgage. Guaranteed loans will additionally require borrowers to meet the credit and income requirement of the lender.
- The USDA guaranteed loan has both 15-year and 30-year fixed-rate options and a USDA-approved lender will determine the interest rate. USDA direct loans have repayment options of 33 years and 38 years depending on income level. The government sets the interest rates for direct home loans.

Conventional/Non-Conforming

Jumbo loan – Loan that exceeds conforming loan limits. Extra-large loans are sometimes called super jumbos.

- About half of jumbo loans are ARMs
- Higher interest rates
- Used to purchase very expensive homes
- Loan is above normal mortgage limits
- FNMA/FREDDIE MAC define loan amount limits for traditional and jumbo loans
- Dollar loan amount limits subject to change each year

Products referred to variously as “non-traditional”, “alternative”, or “exotic” mortgage loans include:

- “Interest-Only mortgages
- “Payment Option” adjustable-rate mortgage

These products:

- Allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period
- Allow borrowers to defer payment of principal and sometimes interest
- Offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages

The Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators are concerned that some borrowers may not fully understand the risks of these products, because:

- The lack of principal amortization and potential for negative amortization

- Providers are increasingly combining these loans with other features that may compound risk (includes simultaneous second-lien mortgages and the use of reduced documentation in evaluating an applicant's creditworthiness)

Alt-A Mortgage aka Alternative A-paper

- Loans lacking full documentation
- Riskier than A paper or "prime"
- Less risky than subprime
- Usually these type borrowers have:
  - Stated income
  - DTI ratios above investor guidelines
  - Low FICO (Fair Isaac Corporation; also known as credit score)
  - High LTV
- Interest rates determined by credit risk

Alternative Documentation Loans

- Same risks as full documentation
- Uses alternative documents to verify information

Example: Instead of verification of employment form and verifications of deposit, lender will use W-2's, paycheck stubs and bank statements

Conventional/Non-Conforming

Sub-prime Lending – Involves making risker loans

- A credit = Prime or standard financing
- A- to B, C, D credit = Subprime financing

Conventional/Non-Conforming

Subprime lending may involve:

- Poor credit rating
- Lack of documentation
- High debt ratio
- Nonstandard property
- Large loan amount
  - Jumbo or Super Jumbo loans
    - Loan is above normal mortgage limits
    - FNMA/FREDDIE MAC define loan amount limits for traditional and jumbo loans. Dollar loan amount limits subject to change each year.

Sub-Prime Rates and Fees

- Subprime lenders charge higher interest rates and higher loan fees in exchange for more flexible underwriting standards and are more likely to have features such as:
  - Prepayment penalties
  - Balloon payments
  - Negative amortization
- Subprime lenders often engage in predatory lending practices

Sub-Prime and Secondary Market

- Secondary subprime markets grew in 1990s
- HUD encouraged Fannie Mae and Freddie Mac to enter subprime market to meet affordable housing goal with Government - Sponsored Enterprises (GSEs) only purchasing very top layer of market
- Subprime boom ended in the late 1990s when the default rate rose, and most subprime lenders went out of business.
- Market continues to grow at steady rate today, but prime loans remain the standard.

Housing Bubble

- Artificial inflation of property values
  - Under the guise of bringing the dream of homeownership to people.
- Community Reinvestment Act

    - Banks had to report number of mortgage loans to low and moderate income people

Conventional/Non-Conforming

Subprime Lending Statement

The federal financial regulatory agencies -the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration, issued the Statement on Subprime Mortgage Lending.

- This statement addresses issues in regards to certain subprime mortgage lending practices, including certain ARM products that can cause payment shock.
- This statement goes on to include safety and soundness standards and consumer protection standards for institutions to follow to ensure the borrower is protected. This is to ensure the borrowers are entering into loans they will be able to pay.

Some characteristics of Subprime Loans

- Some characteristics of these products are:
- Low initial payments based on a fixed introductory rate expiring after a short term, for example one year
- No payment caps on the monthly principal and interest payment or on the interest rate
- Low or no documentation of income
- Considerable prepayment penalties
- Product features that will cause the borrower to refinance multiple times in order to have a more affordable monthly payment

The safety standards of this statement on subprime lending include:

- Fully indexed rate, fully amortized qualification for borrowers
- Use of caution with risk-layering features
- Product disclosures that the customer understands
- Limits on pre-payment penalties
    - Allow for a reasonable period of time for borrowers to refinance without penalty
    - At least 60 days before initial fixed rate expires

In general, subprime borrowers may include those with one or two of the following:

- Two or more 30-day delinquencies in the last 12 months or one or more 60-day delinquencies in the last 2 years
- Judgment, foreclosure, repossession, or charge-off in the previous 24 months
- Bankruptcy in the last 5 years
- Low credit scores
- High debt-to-income ratio
    - 50% or greater

Guidance on Non-Traditional Mortgage Product Risk

The Interagency Guidance on Nontraditional Mortgage Product Risks (NTM Guidance) was issued by the federal financial regulatory agencies. The NTM Guidance was created to illustrate practices to be established by financial institutions associated with underwriting nontraditional mortgage loan products and provide consumers with clear and balanced information prior to making a loan.

The NTM Guidance provides an overview of the loan underwriting standards, portfolio and risk management practices, and consumer protection issues for loan products that allow borrowers to defer payment of principal, and, sometimes, interest.

(Highlights taken directly from the FDIC, FIL-89-2006, 10/5/06)

The NTM Guidance stresses that financial institution management should:

- Assess a borrower's ability to repay the loan, including any balances added through negative amortization, at the fully indexed rate that would apply after the introductory period, assuming a fully amortizing repayment schedule;
- Recognize that certain nontraditional mortgage loans warrant strong risk management standards as well as appropriate capital and loan loss reserves; and
- Ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

The HE Addendum offers additional guidance for managing risks associated with open-end home equity lines of credit (HELOCs) that contain interest-only or negative amortization features.

Both risk management and compliance examiners will carefully scrutinize institutions' processes, policies and procedures to ensure that their practices adequately address the risks posed by these products.

Mortgage Loan Products: Fixed Rate Loans

Interest rate charged on loan remains constant through loan term

- Considered industry standard
- When market rates vary, loan rates do not

Repayment Periods

- Can range from 10-40 years
- 30-year loans still standard
- 15-year loans gaining popularity

Amortization – The paying off of debt in regular installments, or payments of principal and interest, over a period of time to gradually reduce funds owed

Most conventional loans are fully amortized

Mortgage Loan Products: Adjustable Rate Loans (ARM)

ARM allows lender to adjust loan's interest rate to reflect changes in cost of money

- Transfers risk of rate fluctuations to borrower
- Generally lower interest rate than fixed-rate loans

How ARMs work:

- Borrower's interest rate first determined by market interest rates at time loan is made
- After loan made, interest rate tied to an index and adjusted accordingly
  - Index chosen by lender when loan made

ARM may have all or some of these elements:

- Note rate
- Index
- Margin
- Rate adjustment period
- Mortgage payment adjustment period
- Look-back period
- Interest rate cap
- Mortgage payment cap
- Negative amortization cap
- Conversion option

NOTE RATE:

- A loan's note rate is its initial interest rate, as stated in promissory note
- Lenders used to attract borrowers by offering discounted initial rate lower than index rate
- Initial rate can be fixed for one, three, five, ten years, etc.
  - For ARMS with initial periods of five years or less
  - Borrowers will be qualified at the greater of the note rate plus two percent, or
  - The fully indexed rate (index plus margin)

INDEX:

- An index is a statistical report used as an indicator of changes in cost of money
- Several published indexes used by lenders:
  - Treasury securities indexes
  - 11th District cost of funds index
  - LIBOR index

MARGIN:

- ARM's margin is difference between index rate and interest rate lender charges borrower
- Lenders add margin to index to cover administrative expenses and provide profit

Mortgage Loan Products: Adjustable Rate Loans (ARM)

RATE ADJUSTMENT PERIOD:

- ARM's interest rate is adjusted only at specified intervals
    - Such as every 6 months, once a year, or every 3 years
    - One-year adjustment period most common
    - Lender checks index at end of period and adjusts interest rate

Hybrid ARMs – Combination of ARM and fixed-rate loan with two-tiered adjustment structure. Longer initial period, with more frequent adjustments after that.

NOTE: When advertising a Hybrid ARM, although the initial rate is fixed for "x" amount of years, it cannot be advertised as a "fixed rate"

ADJUSTMENT PERIOD:

- A payment adjustment period determines when lender changes amount of principal and interest payment due to change in interest rate
    - Payment usually adjusted at same time as interest rate
    - But payment amount not always adjusted when interest rate is

LOOK BACK PERIOD:

- Typical look-back period is 45 days.
- Loan's rate and payment adjustments are determined by what index was 45 days before end of adjustment period

INTEREST RATE CAP:

- When ARMs were introduced, borrowers experienced payment shock.
    - *As market interest rates rose, indexes also went up, resulting in sharp increase in monthly payments*
    - *Sharp increase in interest rates meant some borrowers couldn't afford payments anymore*
- Interest rate cap limits how much interest rate on a loan can increase, regardless of index
    - *Prevents monthly payment from increasing too much*
- ARM rate caps limit how much interest rate can increase
    - *Per adjustment period*
    - *Over the life of the loan*

MORTGAGE PAYMENT CAP:

- A payment cap directly limits how much a mortgage payment can increase
- Many ARMS only have interest rate cap, and no payment cap

Mortgage Loan Products: Adjustable Rate Loans (ARM)

Negative amortization:

- Negative amortization occurs when unpaid interest is added to principal balance of a loan, increasing amount owed
    - *Normally, loan balance declines steadily*
- Negative amortization causes principal balance to go up instead of down
- ARM features that can lead to negative amortization:
    - *Payment cap without rate cap*
    - *Payments adjusted less often than interest rate*
- Today, lenders rarely make ARM loans that allow negative amortization
- But if it is a possibility, lenders will include a negative amortization cap
    - *Limits amount of unpaid interest that can be added to principal balance*

EXAMPLE

- W borrows $190,000 to buy home. Loan is a one-year ARM with 7.5% annual payment cap. No interest rate cap. Initial interest rate: 4.5%. Monthly payment: $962.70
- By end of first year, index of ARM has risen 2.75%. Lender adjusts loan by 2.75%. Without payment cap, monthly payment would increase by $325
- But W's payment cap limits increase to 7.5% of payment amount per year—preventing payment from increasing enough to cover interest charged for second year

Negative amortization:

- Lender adds unpaid interest to loan balance – negative amortization
  - Causes size of loan to grow
  - When a limit of growth is reached, loan is recast
  - The recast with new payment is often much higher than initial payment
  - Can recast every 5 years
  - New payment may be unaffordable

CONVERSION OPTION:

- Many ARMs allow borrower to convert loan to fixed-rate mortgage at certain times during loan term
  - Usually involves a limited time to convert, and requires a conversion fee

Mortgage Loan Products: Balloon/Reset Mortgages

Characteristics of balloon/reset mortgages:

- Two types: 5/25 and 7/23
- At end of initial 5- or 7-year period, entire loan balance is due
- Payment amounts based on 30-year amortization schedule

At end of initial period, borrowers may either:

- Refinance
- Pay off loan balance
- Reset loan

By resetting loan, loan remains in place and interest rate is set at current market rate:

- Avoids refinancing charges
- Borrowers can't be delinquent on payments
- No other liens may exist on property

Mortgage Loan Products: Reverse Mortgage/HECM

Allows older homeowners to convert equity into a monthly source or line of credit

- Both borrowers must be 62 years old
- Must own the property outright or paid down a considerable amount
- Occupy the property as a principal residence
- Not be delinquent on any federal debt
- Participate in a consumer information session given by a HUD-approved HECM counselor

Property requirements:

- Single family
- 2-4 unit – (One must be occupied by borrower)
- If condo, must be HUD approved project
- If manufactured home, must meet FHA requirements

Financial requirements:

- Income, assets, living expenses and credit history will be verified
  - No income or credit qualifications
- Must have record of timely payments with real estate taxes, homeowners and flood insurance
- No repayment as long as property remains the principal residence
- Closing costs can be financed

Costs involved:

- Mortgage insurance premium
    - *Guarantees borrower will receive loan advances*
- Third party charges such as appraisal, title search, title insurance, surveys, inspections, recordation and other fees
- Origination fee *(Popup to flesh out Origination fee)*
    - Fee to process loan
    - Up to $2,500 if home is valued at less than $125,000
    - Homes valued at more than $125,000
        - 2% of the first $200,000
        - Plus 1% over $200,000
- Servicing fee
    - Charge for sending account statements, disbursing loan proceeds, and tracking taxes and homeowner's insurance to make sure payments are made and up to date

Mortgage Loan Products: Reverse Mortgage/HECM Standard:

- Mortgage Insurance Premium/MIP
    - 2% of maximum claim amount or appraised value
        - Lesser of the two
        - One-time fee
        - Can be financed into loan
    - Plus annual MIP premium thereafter equal to 1.25% of loan balance

Mortgage Loan Products: Reverse Mortgage/HECM Saver

- For homeowners who want to borrow a smaller amount
- Lower proceeds in exchange for lower costs
- Initial mortgage insurance premium
    - 0.01% of loan amount *(Popup example)*

Example:

Loan amount =$100,000
HECM Saver MIP costs = $10
HECM Standard MIP costs = $2,000
Annual MIP = 1.25% (Same as HECM Standard)

MIP guarantees:

- If loan servicer goes out of business, government will step in and ensure homeowner has access to funds
- Guarantees homeowner will never owe more than value of home when HECM is repaid
- Lender recovers amount borrower when property is sold
- If sale exceeds amount owed, proceeds go to owner
    - If sale is less, FHA will cover

HECM can be used for purchase

- 1-4 principal unit
- Not for second home or investment

Example:

The Garcias are empty-nesters who want to downsize from their current home to a nearby condominium. The condo's asking price is $210,000. They anticipate that they will net $190,000 from the sale of their current home, but this won't be enough to purchase the new condo outright.

The Garcias decide to use an FHA HECM to buy the condo. The HECM loan amount is $120,000. That amount, plus $90,000 of their own funds (out of the sale proceeds from their current home), is enough for the condo purchase price ($120,000 + $90,000 = $210,000).

Others – Lower Initial Down Payment

- Many first-time buyers are just starting their careers and expect their incomes to increase steadily.
- Loans with lower initial payments include:
    - Hybrid ARMs
    - Two-step mortgages
    - Balloon/reset mortgages
    - Interest first mortgages

Others – Two-step Mortgages

- Characteristics of two-step mortgages:
  - 30-year term
  - Lender can adjust interest rate once during loan term
  - Offered at lower initial rate than fixed-rate loans
  - Two common types: 5/25 and 7/23
    - 5/25 loan is automatically adjusted after five years, to the current market rate
    - 7/23 loan is automatically adjusted after seven years, to the current market rate

Others – Interest First Mortgages

- Commonly called "interest only" mortgages
- *Characteristics of interest first mortgages:*
  - 30-year loan term
  - Interest only payments during first part of loan term (10-15 years)
  - Payments fully amortized for remainder of loan term

Others – Low Down Payment Plans

- Secondary market agencies have developed some conventional loan programs to make home ownership more affordable.
  - Examples of conventional alternatives:
    - Loan with 95% LTV with 3% down payment from borrower's funds, and 2% from alternative sources
    - Loan with 97% LTV with 3% down payment from borrower's funds, and 3% contribution to closing costs from alternative sources
    - Loan with 100% LTV with no down payment from borrower's funds, and 3% contribution to closing costs from alternative sources
- Allowable alternative sources of funds may include gifts, grants, or unsecured loans
- Funds may come from:
  - Relative
  - Employer
  - Public agency
  - Nonprofit organization
  - Private foundation

Others – Low Down Payment Programs - Affordable Housing Programs

- Many conventional loan programs are targeted at low- and moderate-income buyers
  - Buyers qualify if stable monthly income doesn't exceed median income of area
  - Cash requirements reduced
  - Eligibility based on income or property location
    - Available thru local housing finance agencies (This section is referring to housing finance agencies offering conforming special loan programs to low and moderate income buyers. Additional text added for clarification in the course.
- Some programs waive income limits for buyers purchasing homes in low-income or rundown neighborhoods (Can include buyers with income above area median can still qualify)
- Other programs are offered to specific groups such as:
  - Teachers
  - Police officers
  - Firefighters

Others – Accelerated Payment Plans - Bi-weekly Mortgages

- Characteristics of a bi-weekly mortgage:
  - Interest rate and payment amount fixed
  - Payments made every two weeks (26 per year)
  - Each payment equal to half of monthly payment for 30-year, fully amortized, fixed-rate loan
  - Loan paid off in 20-22 years
- Disadvantages for lenders:
  - More work to service 26 payments instead of 12
  - Less of a profit in interest
- Not all lenders offer or accept bi-weekly payments or programs

Others – Accelerated Payment Plans - Growing Equity Mortgages

- Characteristics of growing equity mortgage (GEM):
  - Interest rate is fixed over life of loan
  - First-year payments of principal and interest based on 15- or 30-year loan
  - Payments increased at specified intervals for all or part of loan term
  - 100% of annual payment increase used to reduce principal balance
- Annual payment adjustments usually increased by fixed percentage, such as 3% or 5% per year
- Equity builds up quickly with GEM and actual repayment period depends on interest rate and magnitude of annual payment increases
  - Most GEMs with 30-year stated terms pay off in 11 to 17 years
- Advantages of GEM:
  - Reduced interest costs
  - Lower interest rate
  - Payments are predictable

Others – Types of Real Estate Loans: Junior or Senior Mortgage

- Junior mortgage
  - Mortgage with lower lien priority than another mortgage or deed of trust against same property
- Senior mortgage
  - Mortgage with first lien position (Also called a "first mortgage")
  - Property may be encumbered with two mortgages in several situations:
    - Junior mortgage provides secondary financing to supplement primary loan
    - Purchase mortgage is subordinated to a construction mortgage
    - Home equity loan
  - After foreclosure, junior mortgage paid only after senior lender has been paid in full
    - If proceeds insufficient, junior lender receives nothing
    - Junior lender can still sue borrower, but debt is now unsecured

Others – Types of Real Estate Loans: Purchase money mortgage

- Any mortgage loan used to finance purchase of property that is collateral for loan
- A mortgage buyer gives to seller in seller-financed transaction

Others – Types of Real Estate Loans: Home Equity Loan

- Home equity loan is loan secured by mortgage against borrower's equity in home he/she already owns
  - *Equity – the difference between property's current market value and liens against it*
- Often used to finance remodeling or property improvements. Interest rates higher than purchase loans.
  - *Also used to pay off credit cards*
- Home equity line of credit (HELOC)
  - Line of credit with a limit and minimum monthly payments that homeowners can draw upon as needed and is automatically secured by borrower's home

Others – Types of Real Estate Loans: Refinance Mortgage

- Refinancing refers to a new loan used to pay off existing mortgage against same property.
  - Used to take advantage of market interest rate drop
  - When large balloon payment is required on existing mortgage
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- Monthly payments include property taxes and hazard insurance
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Others – Types of Real Estate Loans: Package Mortgage

- Secured by personal property as well as real property

- Alternatively, personal property may be financed separately, using a separate security agreement
- Lender must file financing statement with Secretary of State
- Key advantage of package mortgage:
    - Mortgage term generally much longer
    - Interest rate may also be lower

Others – Types of Real Estate Loans: Blanket Mortgage

- Secured by more than one parcel of land and contains a partial release clause
    - Partial release clause - requires lender to release some of security property from lien when portion of debt is paid off

Others – Types of Real Estate Loans: Construction Loan

- A short-term loan used to finance construction of improvements on land already owned by borrower
    - Considered high risk loans
    - High loan fees and interest rates
- Fixed disbursement plan
    - Common disbursement schedule for construction loans that calls for a series of predetermined disbursements (obligatory advances) at certain stages of construction
    - Interest starts to accrue at first disbursement
- Once construction is complete, the construction loan is replaced by take-out loan
    - Borrower repays amount borrowed over specified term

Others – Types of Real Estate Loans: Non-Recourse Mortgage

- Gives lender no recourse against borrower
    - Lender's only remedy in event of default is foreclosure on collateral property
    - Borrower is not personally liable for loan repayment

Others – Types of Real Estate Loans

- Participation Mortgage - allows lender to participate in earnings generated by mortgage property, in addition to collecting interest payments
- Shared appreciation mortgage – entitles lender to a share of increases in property's value.
- Wraparound mortgage – new mortgage that includes existing first mortgage on property
    - Used almost exclusively in seller-financed transactions

LESSON SUMMARY

Conventional Loans

- Any institutional loan that isn't insured or guaranteed by a government agency

Conforming loan

- Complies with Fannie Mae/Freddie Mac guidelines.

Non-conforming loan

- Does not comply with Fannie Mae/Freddie Mac guidelines.
- Majority of non-conforming loans are subprime loans

Owner Occupancy Rules

- Conventional loan may be secured by:
    - Principal residence, (up to 4 dwelling units)
    - Second home, (no more than 1 dwelling unit)
    - Investment property, (borrower doesn't intend to occupy property)
    - Allowed maximum properties financed
    - FNMA will allow ownership interest in up to 10 properties with the following guidelines:
        - 25% down payment on the investment property
        - Minimum credit score of 720
        - No mortgage late pays w/in the last 12 months
        - No bankruptcies or foreclosures in the last 7 years
        - 2 years of tax returns showing rental income from all rental properties
        - 6 months of PITI reserves on each financed property

Loan Amounts

- Conforming loan limits are set annually by Fannie Mae and Freddie Mac
  - Agencies won't purchase loan if it exceeds limit
  - Different loan limits for different parts of U.S.

Jumbo loan

- Loan that exceeds conforming loan limits. Extra-large loans are sometimes called super jumbos
  - About half of jumbo loans are ARMs
  - Higher interest rates

Loan-to-Value Ratios

- Common conventional LTVs: 80%, 90%, 95%
- Less common conventional LTVs: 97% & 100%
- Conventional loans are often categorized by LTV ratio, with different underwriting rules applied to each category
- Fannie Mae and Freddie Mac require private mortgage insurance for any conventional loan with LTV over 80%
- High-LTV loans also have:
  - Higher interest rates and fees
  - Stricter underwriting rules
- If certain conditions are met both Fannie Mae and Freddie Mac are willing to buy ARMs with LTVs up to 95%

Private mortgage insurance (PMI)

- PMI is designed to protect lenders from risk of high-LTV loans and makes up for reduced borrower equity.

Secondary Financing

- Lenders generally allow secondary financing with some restrictions to offset the additional risk:
  - Borrower must qualify for payments on both first and second mortgages
  - Borrower must make 5% down payment
  - Scheduled payments must be due on regular basis
  - Second mortgage can't require balloon payment less than 5 years after closing
  - If first mortgage has variable payments, second mortgage must have fixed payments
  - No negative amortization
  - No prepayment penalty

Piggyback loan

- Is another term for secondary financing and is used to either:
  - Avoid paying private mortgage insurance
  - Avoid jumbo loan treatment

Bi-Weekly Payment Plan

- Mortgagor pays ½ normal payment every two weeks
  - 26 payments made annually
  - 13 payments a year instead of 12
  - Resulting in one extra payment a year
  - Equals an earlier payoff time

FHA

- Federal Housing Administration (FHA) was created in 1934 as part of National Housing Act to:
  - Generate new jobs by increasing construction activity
  - Stabilize mortgage market
  - Promote financing, repair, improvement, and sale of real estate
- Today, the FHA is part of Department of Housing and Urban Development (HUD)
  - Primary function is insuring mortgage loans
  - Compensates lenders for losses from borrower default
  - Does not build homes or make loans

Mutual Mortgage Insurance Plan

- FHA insurance program funded by premiums paid by FHA borrowers.
- Direct endorsers - lenders authorized to handle entire underwriting process for FHA loans.
- If FHA borrower defaults on loan:
  - FHA reimburses lender for full amount of loss
  - Borrower required to repay FHA

Distinguishing features of FHA loans:

- Less stringent qualifying standards.
- Borrowers with minimum decision credit score at or above 580 are eligible for maximum financing
- 3.5% down payment
- Borrowers with minimum credit score between 500 and 579 – limited to 90% LTV
- Borrowers with minimum credit score of less than 500 are not eligible for FHA-insured mortgage financing
- Secondary financing restrictions.
- Max loan amounts set by local limits and by LTV rules
- Borrower must come up with min cash investment plus funds for: Closing costs, Discount points and Prepaids
- Mortgage insurance always required
- No pre-payment charges
- Property must be owner-occupied primary residence

VA

- The VA loan program was established to help veterans finance the purchase of their homes and offers many advantages over conventional financing.
- VA-guaranteed loans are made by institutional lenders, but a portion of loan is guaranteed by Department of Veterans Affairs and protects lender against losses from default.
- May be used for finance, purchase or construction of a one-to-four unit residences
  - Does not guaranty investor loans
  - Veteran must occupy home

Characteristics of VA loans:

- No down payment required
- No maximum loan amount
- No maximum income limits
- Least stringent qualifying standards
- Can be fixed-rate or ARM loans
- No mortgage insurance required
- No maximum interest rate
- Lender may charge flat fee of no more than 1% for administrative costs
- No prepayment penalties
- Forbearance extended to veterans with financial difficulties
- Can be assumed by creditworthy buyer, veteran or non-veteran

USDA Rural Loans

- Provides homeownership opportunities to rural Americans
  - Includes home renovations
  - Also programs for the elderly, disabled or low-income of multi-unit housing buildings

Highlights of USDA Loans:

- 100% Financing
- Broad location guidelines
- No mortgage insurance requirement
- No seller contribution limit
- 100% of closing costs can be gift
- Loan amount can include closing costs and repairs up to a/v

Jumbo Loans

- Loan that exceeds conforming loan limits. Extra-large loans are sometimes called super jumbos.
  - About half of jumbo loans are ARMs
  - Higher interest rates
  - Used to purchase very expensive homes
  - Loan is above normal mortgage limits
  - FNMA/FREDDIE MAC define loan amount limits for traditional and jumbo loans
  - Dollar loan amount limits subject to change each year

Non-traditional financing

- Products referred to variously as “non-traditional”, “alternative”, or “exotic” mortgage loans include:
  - “Interest-Only” mortgages
  - “Payment Option” ARM
- These products:
  - Allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period
  - Allow borrowers to defer payment of principal and sometimes interest
  - Offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages

Concerns

- Regulators fear borrowers may not fully understand the risks of these products, because:
- The lack of principal amortization and potential for negative amortization
- Providers are increasingly combining these loans with other features that may compound risk (includes simultaneous second-lien mortgages and the use of reduced documentation in evaluating an applicant’s creditworthiness)

Alt-A Mortgage (aka Alternative A-paper)

- Loans lacking full documentation
- Riskier than A paper or "prime"
- Less risky than subprime
- Usually these type borrowers have:
  - Stated income
  - DTI ratios above investor guidelines
  - Low FICO
  - High LTV
- Interest rate is determined by credit risk

Alternative Documentation Loans

- Same risks as full documentation
- Uses alternative documents to verify information
  - Example: Instead of verification of employment form and verifications of deposit, lender will use W-2's, paycheck stubs and bank statements

Sub-prime lending

- Subprime lending involves making riskier loans
  - A credit = Prime or standard financing
  - A- to B, C, D credit = Subprime financing
- Subprime lending may involve:
  - Poor credit rating
  - Lack of documentation
  - High debt ratio
  - Nonstandard property
  - Large loan amount – Jumbo or Super Jumbo loans
    - Loan is above normal mortgage limits
    - FNMA/FREDDIE MAC define loan amount limits for traditional and jumbo loans
    - Dollar loan amount limits subject to change each year

Sub-Prime Rates and Fees

- Subprime lenders charge higher interest rates and higher loan fees in exchange for more flexible underwriting standards
- More likely to have features such as:
  - Prepayment penalties,
  - Balloon payments, and
  - Negative amortization
- Subprime lenders often engage in predatory lending practices

Sub-Prime and Secondary Market

- Secondary market for subprime loans grew in 1990s
- HUD encouraged Fannie Mae and Freddie Mac to enter subprime market to meet affordable housing goals
    - GSEs only purchasing very top layer of market
- Subprime market boom ended in the late 1990s
    - Default rate went up
    - Subprime lenders went out of business
- Market continues to grow at steady rate today, but prime loans remain the standard.

Housing bubble

- Artificial inflation of property values
- Community Reinvestment Act
    - Banks had to report # of mortgage loans
    - Low and moderate income people

Fixed rate loan

- Interest rate charged on loan remains constant through loan term
    - Considered industry standard
    - When market rates vary, loan rate doesn't

Repayment periods

- Can range from 10-40 years
- 30-year loans still standard
- 15-year loans gaining popularity

Amortization

- The paying off of debt in regular installments, or payments of principal and interest, over a period of time to gradually reduce funds owed
- Most conventional loans are fully amortized

Adjustable Rate Loan (ARM)

- ARM allows lender to adjust loan's interest rate to reflect changes in cost of money
    - Transfers risk of rate fluctuations to borrower
    - Generally lower interest rate than fixed-rate loans
- How ARMs work
    - Borrower's interest rate first determined by market interest rates at time loan is made
    - After loan made, interest rate tied to an index and adjusted accordingly. Index chosen by lender.
- Characteristics of ARMs
    - ARM may have all or some of these elements:
        - Note rate
        - Index
        - Margin
        - Rate adjustment period
        - Mortgage payment adjustment period
        - Look-back period
        - Interest rate cap
        - Mortgage payment cap
        - Negative amortization cap
        - Conversion option

Note rate

- A loan's note rate is its initial interest rate, as stated in promissory note
- Lenders used to attract borrowers by offering discounted initial rate lower than index rate
- Initial rate can be fixed- one, three, five, ten years, etc.
    - For ARMS with initial periods of five years or less
    - Borrowers will be qualified at the greater of the note rate plus two percent, or
    - The fully indexed rate (index plus margin)

Index
- An index is a statistical report used as an indicator of changes in cost of money
- Several published indexes used by lenders:
    - Treasury securities indexes
    - 11th District cost of funds index
    - LIBOR index

Margin
- ARM's margin is difference between index rate and interest rate lender charges borrower
- Lenders add margin to index to cover administrative expenses and provide profit

Rate Adjustment Period
- ARM's interest rate is adjusted only at specified intervals, such as every six months, once a year, or every three years
    - One-year adjustment period most common
    - Lender checks index at end of period and adjusts interest rate

Hybrid ARM
- Combination of ARM and fixed-rate loan with two-tiered adjustment structure. Longer initial period, with more frequent adjustments after that.

    NOTE: When advertising a Hybrid ARM, although the initial rate is fixed for "x" number of years, it cannot be advertised as a "fixed rate"

Adjustment Period
- A payment adjustment period determines when lender changes amount of principal and interest payment due to change in interest rate
    - Payment usually adjusted at same time as interest rate
    - But payment amount not always adjusted when interest rate is

Look Back Period
- Typical look-back period is 45 days.
- Loan's rate and payment adjustments are determined by the index 45 days before end of adjustment period.

Interest Rate Cap
- When ARMs were introduced, borrowers experienced payment shock.
- Interest rate cap limits how much interest rate on a loan can increase, regardless of index
- ARM rate caps limit how much interest rate can increase

Mortgage Payment Cap
- A payment cap directly limits how much a mortgage payment can increase
- Many ARMS only have interest rate cap, and no payment cap

Negative Amortization
- Negative amortization occurs when unpaid interest is added to the principal, increasing the amount owed
- Negative amortization causes principal balance to go up instead of down
- ARM features that can lead to negative amortization:
- Today, lenders rarely make ARM loans that allow negative amortization
- But if it is a possibility, lenders will include a negative amortization cap
- Causes size of loan to grow
- When a limit of growth is reached, loan is recast
- The recast with new payment is often much higher than initial payment
- Can recast every 5 years
- New payment may be unaffordable

Conversion Option
- Many ARMs allow borrower to convert loan to fixed-rate mortgage at certain times during loan term
    - Usually involves a limited time to convert, and requires a conversion fee

Balloon/Reset Mortgages

- Characteristics of balloon/reset mortgages:
  - Two types: 5/25 and 7/23
  - At end of initial 5- or 7-year period, entire loan balance is due
  - Payment amounts based on 30-year amortization schedule
- At end of initial period, borrowers may either:
  - Refinance
  - Pay off loan balance
  - Reset loan
- By resetting loan, loan remains in place and interest rate is set at current market rate:
  - Avoids refinancing charges
  - Borrowers can't be delinquent on payments
  - No other liens may exist on property

Reverse Mortgage - HECM

- Allows older homeowners to convert equity into a monthly source or line of credit
  - Both borrowers must be 62 years old
  - Must own the property outright or paid down a considerable amount
  - Occupy the property as a principal residence
  - Not be delinquent on any federal debt
  - Participate in a consumer information session given by a HUD-approved HECM counselor
- Property requirements:
  - Single family
  - 2-4 unit –
    (One must be occupied by borrower)
  - If condo, must be HUD approved project
  - If manufactured home, must meet FHA requirements
- Financial requirements:
  - Income, assets, living expenses and credit history will be verified (No income or credit qualifications)
  - Must have record of timely payments with real estate taxes, homeowners and flood insurance
  - No repayment as long as property remains the principal residence
  - Closing costs can be financed
- Costs involved:
  - Mortgage insurance premium
  - Third party charges such as appraisal, title search and insurance, surveys, inspections, recordation, etc…
  - Origination fee or Servicing fee
  - Charge for sending account statements, disbursing loan proceeds, and tracking taxes and homeowner's insurance to ensure payments are made and up to date

Reverse Mortgage - HECM Standard

- Mortgage Insurance Premium/MIP
  - 2% of maximum claim amount or appraised value
    - Lesser of the two
    - One-time fee
    - Can be financed into loan
  - Plus annual MIP premium thereafter equal to 1.25% of loan balance

Reverse Mortgage - HECM Saver

- For homeowners who want to borrow a smaller amount
- Lower proceeds in exchange for lower costs
- Initial mortgage insurance premium
  - 0.01% of loan amount
- MIP guarantees:
  - If loan servicer goes out of business, government will step in and ensure homeowner has access to funds
  - Guarantees homeowner will never owe more than value of home when HECM is repaid
  - Lender recovers amount borrower when property is sold
  - If sale exceeds amount owed, proceeds go to owner
  - If sale is less, FHA will cover
- HECM can be used for purchase:
- 1-4 principal unit
- Not for second home or investment

Others loans – Lower Initial Down Payment

- Many first-time buyers are just starting their careers and expect their incomes to increase steadily.
- Loans with lower initial payments include:
  - Hybrid ARMs
  - Two-step mortgages
  - Balloon/reset mortgages
  - Interest first mortgages

Two-step Mortgages

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Introduction

- Term Loans
- Fixed Rate Level Annuity Loans
- Alternative Mortgage Instruments (AMI)
- Adjustable Rate Mortgages (ARM's)
- Bi-Weekly Loans
- Growing Equity Mortgage (GEM)
- Shared Appreciation Mortgages (SAM)
- Shared Equity Mortgage (SEM)
- Graduated Payment Mortgages (GPM)
- Buydown or Temporary Buydown Mortgages
- Construction Loan
- Piggyback Loan
- Home Equity Lines of Credit (HELOC's)
- Wraparound Loans
- Reverse Annuity Mortgage (RAM's)

In structuring loan agreements, several alternatives may be designed to offer differing loan re-payment plans that benefit both lenders and borrowers. The payment plans may be designed to establish a pattern of continuity that gives borrowers a level of certainty with respect to their financial obligation. In periods of rising borrower's loan qualification, prospects from conventional institutional lenders can result in either a postponement of the purchase decision or entry into some form of seller-financing arrangement, which may not be a good alternative due to some inherent risks associated with financing mechanisms, such as installment sales or contracts for deed. To circumvent these limitations, the real estate financial sector developed a variety of alternative mortgage instruments which help both borrower and lender to move forward with a transaction. Although the range of AMI's have been constrained more recently by new and expanding regulations, several still exist and remain a standard component of the mortgage loan offerings made available by many lenders. The most popular, by far, is the Adjustable Rate Mortgage (ARM), which has many variants and has evolved over the past 20 or so years. The following lesson is a brief discussion of the most common loan types and structures that may be used in typical residential mortgage transactions

Term Loans are more common in business and commercial lending, but they have found acceptance in some residential lending in certain circumstances and in response to certain market conditions. In fact, prior to the advent of the long term level annuity loan in the 1930's, this was a dominant structure for residential and farm loans. A straight or term loan is characterized by periodic payments of interest, followed by a single lump sum re-payment of the loan principal at the end of the term.

The lump sum due at the term's end is called a balloon note payment. Extending existing terms is referred to as "rolling over" the loan.

Terms may be as short as one month, or one quarter, but usually not longer than five years. Term loans are typically for one year periods.
Fixed Rate Level Annuity Loans have been and will, in all likelihood, continue to be the "bread and butter" of the mortgage lending industry.

It is the mortgage type that has facilitated home ownership since the 1930's, and presents a form and manner of payment that best enables borrowers to budget monthly expenses due to the contractual certainty of the amortization schedule. This is one reason why this "old standard" of the home lending business is sometimes referred to as a Budget Loan. This name has nothing to do with affordability, but everything to do with predictability. Consequently, it has been the loan of choice by an overwhelming majority of home buyers, assuming they could meet affordability and qualification guidelines.

When this becomes an issue, borrowers and lenders both seek alternative means of accomplishing the same goal: making it to the closing table. These alternative means will be discussed a little later. However, suffice it to say that, at this point, any loan form which is considered an alternative or Alternative Mortgage Instrument (AMI) is an alternative to the old standard fixed rate fully amortizing level annuity loan.
A fully amortizing loan is characterized by a series of constant or level (annuity) payments over the life of the loan.

A portion of each payment goes toward paying down the loan balance, while the other portion represents a payment of interest at the contract rate on the outstanding loan balance. In economic terms, this is the "rent" paid by the borrower to use the lender's money for each period the loan remains outstanding. In a fully amortizing loan, payments remain unchanged for each period for the amortization period of the loan.

The amount of interest paid as a part of the periodic payment is highest in the initial periods, and declines thereafter. By the end of the amortization period, the outstanding loan balance will have declined to zero.

The level annuity loan was introduced along with the Federal Housing Administration (FHA) to make housing affordable to the working class, encourage home ownership, and drive the economy to recovery from the Great Recession on the back of the construction industry.

The volatility and generally upward drift of interest rates during the inflationary cycle of the mid to late 1970's and early 1980's, along with relatively rapid rates of house price inflation, pushed affordability out of the reach of large segments of the population.
Traditionally, the standard fixed rate level annuity loan was based on a thirty year amortization period. This was saleable in the secondary market as a conventional loan product and, from the consumer's and lender's viewpoint, was directly competitive with payment periods offered by non-conventional products such as FHA and VA loans. It was also the payment period that structurally produced the greatest affordability for typical home buyers (particularly first timers), and it generally paralleled economic useful life expectations for the assets taken as collateral.

Although a 30 year term creates interest rate risk issues for depository lenders, the ability to sell these loans into the secondary market helps to off load this risk to investors, including Fannie and Freddie. However, as interest rates fall, borrowers' incomes rise and outstanding loan balances decline, shorter term amortization periods become more attractive and possible as a means of accomplishing two goals: building equity faster and reducing the overall interest carry costs on the loan.

To many homeowners, this makes 10 to 15 year amortization periods more attractive and opens the possibility of lowering not only the total cost of interest over the loan's life, but also that of securing a lower contract interest rate on the loan itself. Due to the term structure of the interest rate yield curve, lenders are more inclined to offer lower rate to borrowers who want to shorten their loan payout. This is particularly true for existing customers with demonstrated loan repayment histories, strong net worth and significant accumulated equity in their homes. Shortening payment periods allow the lender to retain the loan as an asset (i.e., book and not sell the loan) while minimizing or mitigating interest rate risk. This is a win-win strategy for both lender and borrower. Of course, its success depends on the borrower's income qualification and the lender's willingness to be flexible in providing good customer service.
Two other forms of amortization are also typically possible. These are partially amortized loans, and loan characterized by negative amortization. Both are a consequence of how the loan is legally structured to accomplish the mutual goals and intents of the lender and borrower.

One, the partially amortized loan has more or less seen a standard of commercial real estate lending for many years, and is sometimes referred to as a Renegotiable Rate Mortgage (RRM), or a Balloon Loan.

The second is largely an outgrowth of the creativity of the lending industry, particularly the creation of AMI's deigned to accommodate income qualification and affordability guidelines in the loan origination process. Loan products resulting in negative amortization have been financially damaging to borrowers, lenders and secondary market investors, and have come under significant regulatory scrutiny, particularly since the most recent 2007/2008 financial markets meltdown.

Partially Amortized loans are structured with amortization payment periods of, say 20 to 30 years, but with a due date term of, say 3 to 5 years.

Contractually, the periodic payments of principal and interest are calculated as if the loan would pay out fully over a 20 or 30 year period.

However, the lender, with concurrence of the borrower, has built into the loan a provision that makes the total outstanding loan balance due and payable at the end of the third year (36th month) or fifth year (60th month), or whatever is agreed upon. The amount due at the end of this term is called a balloon note (thus the name balloon loan), which can be refinanced at the same, or different loan terms by the lender currently holding the mortgage, or by another lender who may offer the borrower better terms and conditions. This type of loan gives both parties the option to review their arrangement with each other and to either continue on, or part company in a mutually agreeable fashion. Again, this is a structure fairly common in commercial real estate lending, although it has found its way into the residential sector at various points over the past twenty to thirty years.

Negative Amortization is somewhat an insidious "disease" that creeps into a loan by virtue of the loan's structuring. It is, for the most part, a periodic increase in the outstanding loan balance, due to the fact that payments being made by the borrower are insufficient to both fully pay the contract rate of interest and contribute to reducing the outstanding loan balance. With every payment, the borrower's outstanding loan amount is actually increasing, as opposed to decreasing, as it is supposed to do in the full amortizing level annuity loan.

This creates several problems for both the lender and the borrower, particularly if home values are stagnant or falling. In such an environment, it might not take long for a loan to go "underwater", leaving the borrower with little or no equity buildup in the property, and the lender with an impaired asset.

This is truly a lose-lose scenario, and one which has unfortunately played itself out in past real estate cycles, including the most recent.

Historically, negative amortization has been evident in certain ARM products, Graduated Payment Mortgages (GPM) and other varieties of interest buy-down loan instruments. Recent regulatory changes and secondary market pronouncements are going to make negatively amortizing loans more difficult to originate and then sell. New Consumer Financial Protection Bureau (CFPB) guidance requires loan originators to make specific and very detailed disclosures about qualified loan products, resulting in negative amortization. This is an outgrowth of the CFPB's implementation of the "ability to repay" provisions of the Dodd-Frank Act (DFA). In response, Fannie and Freddie have announced they will no longer purchase loans subject to the "ability to pay" rule if, among other things, the loan is not fully amortizing. This will greatly limit the availability of products such as GPM's and similar rate buy down loans that structurally include negative amortization by design. This is not necessarily an issue now, but could very well become one for the housing industry if mortgage interest rates begin to climb.

Alternative Mortgage Instruments (AMI) became the weapons of choice in real estate and home mortgage finance in the late 1970's and early 1980's, when interest rates on 30 year fixed rate level annuity mortgages rose to 17% and 18%, and stayed at those levels for what seemed like an eternity for those who made their living building and selling homes, originating loans, and providing services to those doing all of the above. At mortgage rates of 17% to 18%, relatively few households in the U.S. could qualify to purchase a median-priced home, much less anything priced higher.

When faced with this dilemma, one quick solution would be to simply lower prices far enough until consumers could afford 17% to 18% mortgage rates. Of course, this is not necessarily the best solution, and one which inevitably creates a myriad of problems and issues for the real estate industry. Lower prices translate to lower sales commissions for real estate agents and brokers, as well as lower profit margins for builders and unhappy buyers who paid the higher price. Lower prices also imply lower values, which then impairs the loan portfolios of lenders, as well as secondary market investors.

The solution: develop a menu of loan instruments which "artificially" make higher interest rates affordable, at least in the short run. In theory, what happened in the longer run was not the lender's, the builder's or the real estate agent's problem. Very often, however, the imbedded financial "traps" in some of the more exotic AMI's did become the lender's problem, as well as a problem for secondary market investors and the ratings agencies or insurance companies that provided underlying assurances for these instruments

Adjustable Rate Mortgages (ARM's) were among the first variety of AMI's to emerge on the mortgage lending field during the 1980's, and it is the AMI product that has generally lasted longest and accounted for the most significant volume of home lending among those products not of the fixed rate level annuity variety. ARM's remain popular during periods of rising or volatile interest rates, since borrowers are very often qualified for the loan based on payments using the initial or "teaser" rate.

The teaser rate is called that for a good reason: it is lower than rates offered on standard fixed rate level annuity loans, and usually represents a significant increase in possibility of receiving loan approval, particularly for applicants “at the margin”. The teaser rate is also a strategy for lenders to attract (some would say lure) customers into a loan agreement in which they are now sharing some of the risks associated with uncontrollable movements of interest rates in money markets.

This, in essence, shifts some, usually not all, of the interest rate risk on a 30 year amortizing loan from the lender to the borrower. This helps avoid rate shock trauma to the balance sheets of lenders who retain most of their loans and provides additional incentives for secondary market investors attempting to shield themselves from rate and yield volatility.

ARM’s became a standard product of home mortgage lending in 1981 when they were formally authorized by the Federal Home Loan Bank Board (FHLBB), which also established guidelines for their use in all federally-related loan transactions. This set in motion the ability of the FHA and VA to offer similarly structured loan products within their respective insured and guaranteed loan programs.
ARM’s have evolved from their earliest versions (initially called Variable Rate Mortgages or VRM’s), and have been subjected to several iterations of modification to satisfy regulatory pronouncements focused primarily on consumer protection. The basic structure and elements that define and describe an ARM have remained largely unchanged. The following describes the various elements of an ARM and how they are used in structuring a loan:

The Initial or Teaser Rate is the interest rate charged for the initial pre-adjustment period of the loan, which typically ranges from one to five years, and possibly seven, depending on how aggressively lenders want to market ARM products to attract customers. The initial rate usually represents a significant discount from rates at the same time for fixed rate level annuity loans. This could be as much as 250 to 350 basis points lower than the fixed rate loan of equivalent maturity.

Although some lenders offer a deep discount teaser rate for one year (with the rate adjusting annually, thereafter), many lenders will offer slightly higher teaser rates for 3, 5 or 7 years, with the rate adjusting thereafter for the remaining term of the loan. These are typically referred to as 3/1, 5/1, or 7/1 ARM’s, and can be very popular for many borrowers, particularly if their home ownership horizon is three, five or seven years.

This could certainly apply to first time buyers planning to trade up quickly, buyers who hope to “flip” a home and take advantage of generous capital gains treatments, or those expecting a job transfer. For these buyers, ARM’s are usually a very good financial fit.

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The Index is the starting point for calculating a new note rate once the adjustment intervals arrive, and a new monthly payment must be calculated. The Index is typically selected by the lender and fully disclosed to the borrower.

The Index chosen typically reflects a security term structure that closely matches the adjustment interval of the ARM. This is typically one year, but could also be two or even three years. These intervals are rare and are usually included in loans originated that do not conform to secondary market standards.

Indexes are drawn from sources that are reliable in terms of measuring interest rate movements and are readily available in either print form (i.e. Wall Street Journal, Barron’s, etc.) or on the Internet. Among the most commonly used are U.S. Treasury rates for T-Bills and securities; the 11th District Cost of Funds Rate; the Federal Home Loan Bank Rate; and the London Interbank Offered Rate (LIBOR). Once the Index is chosen, the lender is prohibited from changing to another measure for the duration of the loan agreement.

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The Margin is a gross profit factor added to the Index, which determines the new note rate. The margin can range from 200 to 400 basis points, depending on the lender, and is a factor which borrowers can use in shopping for the loan which is in their financial best interest.

Different lenders will offer different margins, but due to competitive market pressures, there is typically a relatively tight range of margin offerings.

In most cases, it is best to secure a loan with the lowest possible margin, since this is fixed for the duration of the loan agreement, while the Index is subject to potentially wide swings in market interest rates, particularly in periods of economic uncertainty.

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The Note Rate is the result of combining the Index and the margin. It is the rate that is used to determine the monthly payments due for each internal adjustment period over the remaining life of the loan. Depending on the movement of interest rates and thus, the indexes, monthly payments will fluctuate up or down until the loan is either paid off, refinanced, or converted to a fixed rate level annuity payment loan. In very early versions of ARM loans, payment and rate shock were not uncommon, particularly if money markets had proven to be more volatile than anticipated.

In some cases, new note rate payments rose significantly, thus putting financial stress on the borrower. In best case scenarios, lenders would work with borrowers to lessen the pain and mitigate the risk of default and foreclosures. However, in more than a few instances, the worst case scenario unfolded with borrowers finding themselves in default and, very shortly thereafter, losing their home to foreclosure. The latter scenario's occurrence was significantly heightened when economic conditions became strained and unemployment rates crept up.

In an attempt to mitigate and reduce the risk of payment shock induced defaults, ARM product offerings were modified to incorporate CAPS on both adjusted rates and their resulting payments.

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The Rate Cap is the most commonly used of the two and is designed to protect the borrower from unlimited interest rate increases from one interval to the next. The most commonly quoted Caps are "2 and 6". This means that the most the interest rate on the loan will adjust from the Initial Rate on the loan for each interval is 2%, or 200 basis points, while over the life of the loan; the rate adjustment will never exceed 6% or 600 basis points. These Caps provide a level of protection for the borrower, and allows the lender to evaluate the loan's risk profile even under a worst case scenario. For most lenders and borrowers, having to face the prospect of a 600 point sudden movement of interest rates, is relatively remote.

At the same time, the Caps allow the borrower to find some comfort in budgeting forward their loan payments at least for two to three years from when the rate adjustments begin. Rate Caps are all subject to full disclosure by the lender; become fixed for the duration of the loan; and do not create a situation in which the loan becomes subject to negative amortization (which is not the case with Payment Caps).

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Payment Caps are structured so that after application of the appropriate Index and Margin, the new resulting payment cannot increase more than some specified percentage, typically 6% to 7%. If the resulting payment increases by more than the Cap allows (say $200), this amount of uncollected payment due (as per the Margin and Index) is added to the outstanding loan principal, thus producing negative amortization.

Because of negative amortization, the use of Payment Caps has largely given way to reliance on Rate Caps.

This does not necessarily fully protect lenders from the full extent of rate movements possible from one interval to the next, but has created a more sound mortgage instrument for the borrower, as well as secondary market investors. *ARM's have evolved from their earliest versions (initially called Variable Rate Mortgages or VRM's), and have been subjected to several iterations of modification to satisfy regulatory pronouncements focused primarily on consumer protection. The basic structure and elements that define and describe an ARM have remained largely unchanged. The following describes the various elements of an ARM and how they are used in structuring a loan:*

The Adjustment Interval, as previously mentioned, can take a number of forms. The most typical is a one year adjustment interval, although there are loan products that adjust every two or three years as well.

At the other end of the adjustment period are loans with six month, or even monthly, intervals. These are most commonly offered in periods of high rate volatility and extreme uncertainty in the economy and money markets. They are typically difficult to sell to borrowers, and for good reason. They give the borrower very little stability in terms of payment expectations, and effectively shift all of the interest rate risk from the lender to the borrower.

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Convertibility is a provision built into the ARM that gives the borrower an option to convert the loan to a fixed rate at certain points during the duration of the mortgage agreement. It is a provision that lenders may build into the loan, but at a cost to the borrower.

The conversion rate is very often set at a level slightly higher than the market rate existing at the time of conversion. It may, however, be an attractive alternative for borrowers expecting a decrease in income, which could make qualifying for a new loan or refinancing difficult.

In most cases, borrowers choosing this option are not required to qualify for the new conversion rate, although it may be advisable for the lender to review their credit status, and possibly make other adjustments to the loan agreement to provide greater assurance of its underlying integrity.

Bi-Weekly Loans

Bi-Weekly loans are a variant of a fixed rate level annuity loan, which simply increases the frequency of payment, while in the process of reducing the loan's overall interest carry costs. This type of loan may be particularly useful and beneficial for borrowers who are paid every other week, since this payment method might be easier to budget. The calculation for such a payment amount is simply one-half of a monthly payment, paid bi-weekly. For example, if the monthly payment for a 20 year loan amounts to $1,000, the borrower would pay $500 every other week. This amounts to 26 bi-weekly payments over the span of one year, amounting to $13,000. This compared to 12 monthly payments amounting to $12,000.

The additional payments applied to principal reduction in the bi-weekly plan will help pay off the loan in about 17 to 20 years, depending on the contract rate of interest. This type of loan has been approved for purchases by Fannie Mae, thus loan originators can offer this kind of loan and be assured of it being saleable in the secondary market. Many lenders who offer this loan product may require direct drafts of the bi-weekly payments from the borrower's checking account.

Growing Equity Mortgage (GEM)

A Growing Equity Mortgage (GEM) is another method that can be used to shorten a loan and thus reduce interest costs. It is sometimes referred to as a graduated equity mortgage produce. Many variations are available, but the basic pattern is for the borrower to voluntarily make certain increased payments each period.

The entire amount of the increased payment is applied to repayment of the principal. Depending on the interest rate and the amount of increase in periodic payments, terms on a 30 year amortizing loan can be reduced by 40% to about 18 to 20 years. In many instances, the comparable trade- off for the borrower in terms of interest savings would be to secure a 15 year loan. However, such a loan would lock the borrower into higher monthly payments, while the GEM retains the lower payments associated with the longer amortization period. Some borrowers would be reluctant to give up the flexibility to roll back their monthly payments, particularly if their incomes could be subject to unforeseen variability.

The GEM is a loan of convenience for borrowers, which many lenders encourage by not including pre-payment penalties in the loan agreement. Loans such as these are also approved by both FHA and VA. For FHA, this is accomplished within its Section 245 home mortgage insurance program for loans with varying rates of amortization.

Shared Appreciation Mortgages (SAM)

Shared Appreciation Mortgages (SAM) is a loan product that was popular and became practical when interest rates reached record highs in the early 1980s and values were rising at a healthy pace in many regions of the U.S. While current conditions make its use somewhat impractical, the concept is another alternative mortgage method that resurfaces from time to time.

In this loan product, a portion of the collateral's appreciation is accepted by the lender as "contingent interest". When home values were appreciating and interest rates were in the 12 to 15 percent range, some lenders found it profitable to take a portion of the expected return of their money from the collateral's appreciation upon sale or refinancing.

Some lenders active in this type of lending had problems obtaining title insurance with the proper endorsement for appreciation coverage and the accrual of equitable interest when loans such as these have gone into foreclosure. If interest rates rise sharply, this is another AMI which could be resurrected to facilitate transactions in challenging circumstances.

Shared Equity Mortgage (SEM)

A Shared Equity Mortgage (SEM) is sometimes confused with shared appreciation mortgage, but the two are quite different in both structure and underlying intent. In a shared appreciation mortgage, a lender or other investor subordinated to the mortgagee holds a claim, or lien, on that portion of the property value that represents an increase from the time of loan origination. This claim is granted in return for their consideration in making the loan, for contributing to the down payment and, in some cases, for both.

The shared equity loan may be used in a family situation where a parent helps a child or relative purchase a house or by an employer trying to attract a new employee at a time when starting salaries are insufficient to purchase houses in a high-cost area. Alternatively, a shared equity loan might be used as an incentive to encourage an employee to move to a remote or less desirable area. Typically, the employee in most cases is given an option to buy out the employer's share within a limited number of years. In case of a transfer, the employer would typically agree to purchase the entire property at fair market value.

This, too, is a mortgage instrument of convenience used to facilitate particular types of transactions, and it has been used successfully in that regard. Recent regulations, however, in the form of the 2010 Health Care and Education Reconciliation Act, created potential tax issues for some who may benefit from this type of loan. As such, consultation with a tax advisor is highly recommended before utilizing the SEM.

Graduated Payment Mortgages (GPM)

Graduated Payment Mortgages (GPM) shares the potential drawbacks of some ARM products regarding negative amortization. They also share the same underlying motivation of reducing initial period monthly payments to enhance qualification prospects.

However, unlike ARM's, which are less predictable from one interval to the next with regard to payments, GPM's step up the monthly payments at a pre-determined pace until the loan is then amortized at fixed, level payments. The payments are graduated from a discounted level in the initial year over a three to five year period. At the beginning of, say, the sixth year, the loan is then fully amortized at a note rate of interest for the remaining loan term.

Because the loan has accumulated negative amortization and the term remaining is now 3 to 5 years shorter, the remaining payments very likely are higher than they otherwise would have been in the initial years if the loan payments were more at market rates. It, too, assumes gradual increases in household income and stable to rising property values.

The GPM product, which is sometimes referred to as a buy down loan, was first tested by the FHA as a method of allowing home buyers to pay lower initial monthly payments in the earlier years of a mortgage term, with payments rising in successive years to a level sufficient to amortize the loan within a 30 year term.

With a lower initial monthly payment, the buyers with lower incomes might be better able to qualify for a loan, or allow others to buy a larger home with the same income. In qualifying applicants for this type of loan, it is necessary for them to show reasonable expectations of increases in annual income so as to meet the required increases in monthly payments.

Since making such estimates is difficult at best for many borrowers, the basic foundation of most GPM products could be easily undermined.

Inherent with the GPM is that even a constant level payment, long term mortgage loan allows very little money to be paid on principal in early periods. So, with only a modest reduction in the payment amount, any allocation to principal is easily eliminated, along with a portion of the interest payment due. As a result, there is an accumulation of unpaid interest (*accrued interest*) in the early years of the mortgage term producing a situation where the borrower ends the year with larger principal balance than when the loan was first originated. As mentioned previously, this is *negative amortization,* since the loan balance increases, rather than decreases with each payment. To avoid the possibility that the increasing amount of the loan balance might exceed the initial value of the property serving as collateral, GPMs generally require higher down payments than may be necessary for constant level-payment plan. Down payments for this type of loan are calculated so the loan balance will not exceed the limits permitted, which is 95 percent of the initial property value for conventional loans carrying private mortgage insurance (PMI), and 97 percent of the initial value for FHA insured loans under the fairly popular Section 245 program.

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Buydown or Temporary Buydown Mortgages

Buydown or Temporary Buydown Mortgages are an older variant of GPM's, which have been used successfully to sell homes and complete transactions when more conventional products were rendered unaffordable by high market interest rates. This loan is also referred to as a mortgage differential allowance program that permits the seller of a property to place a portion of the sale proceeds at closing with the lender in an escrow account. These funds are used to reduce the effective interest costs and monthly payments for the first two or three years of the loan.

The buyer makes the offer to purchase, contingent on the seller establishing a mortgage differential account in the purchaser's name, at the time of closing. The account is established so that it has sufficient funds to effectively reduce the purchaser's monthly payment to reflect a lower interest rate for the first few years of the purchaser's loan. The buyer signs the note and mortgage at the current interest rate, but the seller is prepaying interest for the buyer. The differential is placed in a savings account in the purchaser's name, with the lender who makes the loan and draws on this account to equate actual interest payments with those that would have otherwise been received without the buydown.

A 3-2-1 buydown program, for example, offer the buyers a three percent reduction of the first year's rate, a two percent reduction of the second year's rate, and one percent off the third year's rate. These buydowns may be used with almost any type of mortgage, whether VA, FHA, or conventional.

Borrowers may qualify at the first-year rate if they put down 10 percent, or carry no more than a 90 percent loan-to-value (LTV) mortgage. The borrower is required to qualify at the end of note rate on all conventional buydowns if the LTV is greater than 90 percent.

Buydowns can also be used in six month or one year periods, depending on the particular situation of the buyer and the willingness of the seller to subsidize monthly interest payments. Buydown programs, in effect, reduce the net proceeds for a seller and are considered a cost of doing business for homebuilders during periods of high interest and tight credit. As such, buydown costs reduce a builder's profitability, but help to sell inventory and reduce interest carry costs.

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Construction Loan

A Construction Loan is a form of an Interim Loan which is used to cover the costs associated with building, as well as renovating and rehabilitating property. The term "interim" can be applied to other variations of short or intermediate term loans, but in real estate, it's most prevalent use is in association with loans secured by builders or developers to carry out some specific set of tasks which create new, or rehabilitate or adapt existing space. By definition, and in reality, this is a complex process requiring a wide range of skills, talents and materials, all of which expect to be compensated for their efforts. The construction loan is typically the means of providing the funds necessary to pay all of these contributors to the process, along with some equity capital that may have been assembled by the developer/builder.

Construction loans differ from other mortgage loans in that they are funded through periodic advances as construction progresses. The loan may be funded one of two different ways:

1. after certain stages of construction are completed (i.e., foundation, framing, plumbing, electrical, etc.), or
2. over certain time periods (such as monthly) for work completed up to that point. It takes close oversight by the lender to ensure that funds are released as building progresses. Following this process of loan inspection and advances, the value of the building used as collateral should be increasing about the same rate as the amount of the loan outstanding.

The major risk of construction loans is in the ability of the borrower/builder to complete the project within the budget, and according to plans and specifications. Failure to complete the building precludes release of a permanent loan which will pay off the construction loan. Should this occur, the construction loan could be extended by the lender by negotiating what some call a Mini Perm loan.

This loan carries the property until a Permanent Loan can be secured, and may also be referred to as a Bridge or Gap loan. These are, in effect, loans to facilitate a transaction that might otherwise fail and force the lender to foreclose and take the collateral. Since most lenders would prefer to avoid this possibility, these other forms of interim lending provide an alternative.

Construction loans come in two basic varieties: one-time closings and two-time closings. One-time closings are offered by many lenders that originate construction loans. These loans are also called "construction-to-permanent loans" because the loan rolls over from a construction loan to a permanent mortgage once construction is completed.

The one loan means one application and one set of closing fees.

Two-time closing construction loans involve originating a construction loan as an interim loan, where borrowers pay only the interest accrued on the cost of construction. Upon completion, the borrower, if the same as the end-user, must re-qualify and pay the closing costs associated with securing a permanent mortgage on the total value of the property.

Funding of a permanent mortgage after construction is typically guided by the terms of a Takeout Commitment dictated by the lender. The builder/developer typically secures the takeout commitment as a prerequisite to securing an interim construction loan. The reason for this is fairly simple: interim lenders want to remain short to intermediate providers of credit and want to be assured that another funding source has been secured to pay out their loan in full upon the building project's completion.

Prospective construction/interim lenders will review the terms of the takeout commitment very carefully to determine if the borrower has the ability and experience to fully satisfy every condition within the specified period of time. If they have any serious reservations in this regard, the lender will deny the application for the construction loan. Construction lenders can mitigate their risks by linking their approval to a sound takeout letter from a reputable permanent lending source. They cannot, however, guard against every negative possibility that could arise over the construction and development period. As such, many will either not offer construction loans as part of their product/service portfolio, or charge interest risk premiums that encourage prospective borrowers to look elsewhere.

Additionally, lenders must be wary of the regulatory "watchful eye" which treats construction loans as a high risk, no matter the deal structure or the nature of the borrower. As such, too many construction loans on an institution's balance sheet can, and usually does, have negative effects on regulator assessments of asset quality, one of the important CAMELS scoring criteria previously discussed.

Piggyback Loan

A Piggyback Loan is a residential mortgage financing option in which a property is purchased using more than one mortgage from one or more mortgages. Very often, a second mortgage is secured from a lender different from the one providing the first mortgage. However, some lenders offer piggybacks involving maximum FNMA/FHLMC loans as the first, with a HELOC (Home Equity Line of Credit) in second position funding the balance of the acquisition price or refinance amount target.

These loans typically work well for and accommodate upper income borrowers with strong net worth positions and earnings potential. Again, this is a loan product designed to meet the needs of specific borrowers engaged in a particular transaction that proves to be beneficial to both parties.

Home Equity Lines of Credit (HELOC's)

Home Equity Lines of Credit (HELOC's) are forms of equity loans which allow borrowers to secure funding on an as needed basis, rather than a lump sum, up to an approved ceiling or maximum LTV. In essence, this provides the consumer with a revolving Line of Credit that can be used for any purposes desired, including making home improvements, but also purchasing consumer goods, taking vacations, fund education and the like.

From a practical standpoint, the borrower has converted home equity into an ATM cash drawer to be used whenever "needed".

Wraparound Loans

Wraparound Loans, or simply Wraps, became popular during the high interest rate era of the late 1970's to early 1980's. It was another of many creative mortgage structures designed to facilitate transactions for the benefit of everyone involved, but particularly homebuyers and sellers. However, it only works if there is an assumable loan on the property being sold. At this time, this mostly limits its use to properties encumbered by either an FHA or VA loan. In most other conventional loans, the alienation or due on sale clause in the promissory note would preclude its use.

In essence, the wraparound mortgage is two or more mortgages consolidated into one payment, and is usually designed to allow the buyer to purchase with a smaller down payment, with the added benefit of a below market interest rate first mortgage. The sellers receive all of their cash at the time of closing, while the lender wraps new money around an existing assumable loan. If, in the future, the borrowers have sufficient resources available, they could pay off the wrap loan and default to the original low interest mortgage for the rest of the loan's life.

Reverse Annuity Mortgage (RAM's)

Reverse Annuity Mortgage (RAM's) are products designed to have the lender pay the borrower, rather than the other way around. This loan product was first authorized for use by the Federal Home Loan Bank Board (FHLBB) in 1979, and has grown in popularity, particularly among senior citizens ever since then. Very often, those who secure RAM's also drive vehicles with a bumper sticker that says something like "Retired and Busy Spending my Children's Inheritance".

In a reverse annuity mortgage, homeowners 62 years old or older can convert the accumulated equity in their homes into cash. Homeowners can receive these funds as a lump sum, in fixed monthly installments, as a line of credit, or in various combinations. This means that the loan increases each period, which is an exact reversal of the normal process of amortizing down the debt. If the owners sell the home, their equity will naturally be less, but access to spendable income may be more important than accumulated wealth to retirees, and the RAM can provide an income stream, or lump sum payments.

The mortgage does not have to be repaid until the mortgagor moves or dies.

RAM's are available through local banks and savings associations. However, due to the complexity of this loan type, many lenders chose not to offer it in their product portfolio. Loan officers must be specially trained and the originating process can be lengthy and quite tedious. HUD federally insured RAM loans have grown significantly, and has helped expand the number of lenders offering these loans.

LESSON SUMMARY

Term Loans

- A term loan is characterized by periodic payments of interest, followed by a single lump sum repayment of the loan principal at the end of the term.
- The lump sum due at the term's end is called a balloon note payment.
- Term loans are typically for one year periods.

Fixed Rate Level Annuity Loans

- A fully amortizing loan is characterized by a series of constant or level (annuity) payments over the life of the loan.
- A portion of each payment goes toward paying down the loan balance.
- The interest paid as a part of the periodic payment is highest in the initial periods, and declines thereafter.
- By the end of the amortization period, the outstanding loan balance will have declined to zero.
- Standard fixed rate level annuity loans were based on a thirty-year amortization period.
- The thirty-year term creates risk for lenders which is decreased by selling these to investors.
- The 10-15 year loans were attractive because they reduced the loan cost and payoff period.

Partially Amortized Loans

- Structured with amortization payment periods of 20- 30 years, but with a due date term of 3 to 5 years.
- Principal and interest are calculated as if the loan would pay out fully over a 20 or 30 year period.
- The loan is structured so the balance comes due at the end of an agreed upon period – Balloon Payment.

Negative Amortization Loans

- A periodic increase in the outstanding loan balance because the payments don't fully cover interest accrual.
- With each payment the outstanding loan amount increases quickly, driving the loan "underwater."

ARM

- The teaser rates were usually lower than fixed rates and sustained higher approval rates.
- The Initial or Teaser Rate is set during the pre-adjustment period and ranges from one to five years.
- Some teaser rates are set to increase after one year and annually after that, but sometimes are set to increase on 3, 5 or 7 year terms.
- The Index is the starting point for calculating a new note rate once the adjustment intervals arrive and a new payment amount must be calculated.
- The Margin is a gross profit factor added to the Index, which determines the new note rate.
- The Note Rate is the result of combining the Index and the Margin and determines the monthly payments due for each internal adjustment period over the remaining life of the loan.
- To help mitigate risks, caps were added to protect the borrower.
- The Note Rate is the result of combining the Index and the Margin and determines the monthly payments due for each internal adjustment period over the remaining life of the loan.
- The Rate Cap is the most common and protects the borrower from unlimited interest rate increases.
- Payment increases are capped so the increase is not more than a specified percentage, typically 6% to 7%.
- The Adjustment Interval is the typical period between adjustments, typically a year but there are loan products that adjust every two or three years as well.
- Convertibility is a provision built into the ARM that gives the borrower an option to convert the loan to a fixed rate at certain points during the duration of the mortgage agreement.

AMI

- When interest rates rose to 17-18% in the late 70s, lenders began pushing Alternative Mortgage Instruments – AMIs.

Bi-Weekly Loans

- Bi-Weekly loans are a variant of a fixed rate level annuity loan, which simply increases the frequency of payment, while in the process of reducing the loan's overall interest carry costs.
- The additional payments applied to principal reduction in the bi-weekly plan will help pay off the loan in about 17 to 20 years, depending on the contract rate of interest.

Growing Equity Mortgage (GEM)

- The basic pattern for the GEM is the borrower voluntarily makes increased payments each period shortening the loan and reducing interest costs.
- The entire amount of the increased payment is applied to repayment of the principal.

Shared Appreciation Mortgages (SAM)

- A portion of the collateral's appreciation is accepted by the lender as "contingent interest".
- Lenders struggled to obtain title insurance that fully covered appreciation and accrual of equitable interest when these loans went into foreclosure.

Shared Equity Mortgage (SEM)

- In a SEM, a lender or other investor subordinated to the mortgagee holds a claim, or lien, on that portion of the property value that represents an increase from the time of loan origination.
- The SEM is commonly used by a third party to help a family member or prospective employee to secure affordable housing.
- Consultation with a tax advisor is recommended.

Graduated Payment Mortgages (GPM)

- GPM's step up the monthly payments at a pre-determined pace until the loan is then amortized at fixed, level payments.
- Because the loan has accumulated negative amortization and the term remaining is now 3 to 5 years shorter, the remaining payments very likely are higher than they otherwise would have been in the initial years if the loan payments were more at market rates. It, too, assumes gradual increases in household income and stable to rising property values.
- With the GPM at a constant level payment, long term mortgage loan allows very little money to be paid on principal in early periods.
- GPMs generally require higher down payments than may be necessary for constant level-payment plan.

Buydown or Temporary Buydown Mortgages

- This loan is also referred to as a mortgage differential allowance program that permits the seller of a property to place a portion of the sale proceeds at closing with the lender in an escrow account. These funds are used to reduce the effective interest costs and monthly payments for the first two or three years of the loan.
- A 3-2-1 buydown program, for example, offer the buyers a three percent reduction of the first year's rate, a two percent reduction of the second year's rate, and one percent off the third year's rate.

Construction Loan

- A Construction Loan is a form of an Interim Loan which is used to cover the costs associated with building, as well as renovating and rehabilitating property.
- The loan may be funded one of two different ways:
    - after certain stages of construction are completed (i.e., foundation, framing, plumbing, electrical, etc.)
    - over certain time periods (such as monthly) for work completed up to that point.
- A big risk of construction loans is in the ability of the borrower/builder to complete the project within budget, and according to plans and specs.
- Construction loans come in two basic varieties:
    - The one-time closing loan means one application and one set of closing fees.
    - Two-time closing loans involve originating an interim loan, where borrowers pay only the interest accrued on the cost of construction.

- Funding of a permanent mortgage after construction is typically guided by the terms of a Takeout Commitment dictated by the lender. The builder/developer typically secures the takeout commitment as a prerequisite to securing an interim construction loan.

Piggyback Loan

- A residential mortgage financing option where a property is purchased using more than one mortgage from one or more mortgages. Very often, a second mortgage is secured from a lender different from the one providing the first mortgage.
- These loans typically work well for and accommodate upper income borrowers with strong net worth positions and earnings potential.

Home Equity Lines of Credit (HELOC's)

- HELOC's are forms of equity loans which allow borrowers to secure funding on an as needed basis, rather than a lump sum, up to an approved ceiling or maximum LTV.

Wraparound Loans

- Wraparound Loans became popular in the late 70's - early 80's as another creative mortgage product. These are mostly limited to FHA or VA loans.
- The wraparound mortgage is two or more mortgages consolidated into one payment, designed to allow the buyer to purchase with a smaller down payment, with the added benefit of a below market interest rate first mortgage.

Reverse Annuity Mortgage (RAM's)

- With RAM's the lender pay the borrower. They are very popular with senior citizens.
- Homeowners 62 years old or older can convert the accumulated equity in their homes into cash.
- The mortgage does not have to be repaid until the mortgagor moves or dies.

Introduction to Parts 1 & 2
The Major Elements of Mortgage Lending - Part 1

- Qualifying the Property

The Major Elements of Mortgage Lending - Part 2

- Qualifying the Title
- Closing
- Servicing the Loan
- Qualifying the Borrower

Loan underwriting, or qualification, is a crucial step in the real estate lending process for both the lender and the borrower. Loan qualification is a component of the overall loan application process, and includes not only consideration of the value of the collateral pledged as security, as well as the creditworthiness of the borrower(s).

The loan application is a chance for the prospective borrower to convince the lender that loan proceeds will be put to good use, and that they will be paid back as agreed. The lender uses the loan application and review procedures to gather information regarding the property and the borrower to evaluate the potential risks associated with making the loan.

The applicant's credit scores will be retrieved and evaluated within the framework of the loan for which the borrower is applying. Low scores may disqualify an applicant, or place them at a risk profile level requiring more detailed review, supplemental or supporting information, and possibly requiring a higher interest rate on the loan itself.
Loan application and processing includes a two way flow of information between the borrower and lender, some of which are bureaus, land surveyors, building inspectors and real estate brokers or salespersons. In evaluating the borrower, the lender is attempting to assess the four "C's" of credit analysis:

- Credit history
- Character of the borrower
- Capacity to repay
- Collateral value of the asset pledged

Much of the information required for this evaluation is drawn from information provided by the borrower in the loan application, which includes an income statement, balance sheet and employment history. Additionally, the loan officer gathers information through verification of bank and other financial accounts and employment history. The lender requests recent credit reports and may verify through other references the information provided on the application. This information is used primarily to judge the credit history and character of the prospective borrower, as well as to analyze the capacity or ability of the borrower to repay the loan requested when the relationship of monthly debt services payments to income is taken into consideration.

The five major elements of mortgage lending includes:

- Qualifying the property
- Qualifying the Title
- Closing
- Servicing the loan
- Qualifying the borrower

Each requires a variety of individuals with the appropriate skills and experience necessary to complete a successful transaction. Each of these elements also has its own attendant costs and fees associated with it, which can be a fairly significant amount when taken collectively. This somewhat high transaction cost, when compared to those of say, securities or other investment transactions, is a reflection of the imperfectly competitive nature of real estate markets. Transaction costs can be minimized in some instances, but the complexity of the transaction itself and the need for people with specific types of expertise and experience, make keeping costs low challenging. In fact, some would argue that attempting to get a "deal" on some closing and financing fees could very well come back to haunt one or more parties to the transaction. The adage "you get what you pay for" is very applicable, and one that should be considered when one is tempted to take a short cut to lower costs, or retain someone with questionable credentials to provide services.

Qualifying the property is essentially a matter of having the collateral appraised and inspected. The appraisal is focused on establishing a Fair Market Value for loan purposes, while the inspections are to verify the collateral's condition and corroborate disclosures made by the current owners/sellers.

Since appraisal and inspection are covered elsewhere in this course, the discussion here will be somewhat limited. Suffice it to say that property should be thoroughly inspected by a qualified person(s) who can attest to the condition and physical integrity of the improvements. This would include, but not necessarily be limited to, inspections of the roof, foundation, HVAC systems, plumbing and electrical service, as well as specialty items such as swimming pools, hot tubs/spas, outdoor ancillary buildings (i.e., RV storage, shops, barns, etc.). Some inspections, such as for pools and spas, may require a specialist with the appropriate experience and equipment to detect hidden defects such as leaks in pool linings, insufficient pump pressures, and the like.

The results of independent inspection reports should be compared to the seller disclosure statement to identify, clarify and reconcile discrepancies.

The outcome of the inspection may very well dictate whether the next steps of the financing process are embarked upon or terminated if they have already begun. Property inspections are particularly important for older properties, which have been subject to a fair amount of physical wear and tear and functional obsolescence. They are also important in locations that have experienced a significant natural disaster (i.e., flood, hurricane, tornado, etc.) which inflicted widespread property damage. Inspections in these instances should focus on the quality of the reconstruction, particularly the materials used and measures taken to mitigate future risks associated with mold (from flooding) or structural damage (from sustained hurricane force winds). In the latter instance, the inspection should ascertain as well as possible if updated building codes were followed in the reconstruction process.

The appraisal, on the other hand, is primarily concerned with establishing a fair market value for the collateral the lender will be accepting as security for the loan, thus on which they will be placing a lien.

Although the appraiser also must conduct an inspection of the property, it is a more cursory unit to verify its size, general condition and conformity with its immediate surroundings, as well as to determine the type of properties that will be chosen as comparables used to establish indications of market value.

The appraiser must adhere closely to the Uniform Standards of Professional Appraisal Practice (USPAP,) which were an outgrowth of the FIRREA legislation of the 1980's and that have, and continue to undergo, revisions and additions. The results of the appraisal are then compiled and reported (as per USPAP) in one of several ways: an oral report, letter report, form report, or full narrative report. Most residential appraisals are reported on either a FNMA/FHLMC form or on either an FHA or VA approved form. The form of the report, while important, does not alter the methodology required for the appraiser to arrive at a supportable and defensible opinion of market value.

It is important for everyone involved in the transaction to understand that an appraiser is rendering his or her opinion of value.

The opinion is not a fact as such, but is an informed statement by the drawing upon facts extracted from the marketplace, applied within specific methodological steps, reconciled based upon the experience and professional judgment of the appraiser, and rendered as of a specific date. Consequently, the appraisal is subject to review, criticism, alteration, and possibly being completely redone by a different appraiser. Federal regulations have, in effect, created firewalls which separate the appraiser from those who stand to benefit from, or possibly be hurt by the ultimate value opinion rendered.

This means that direct communication between the property owner, real estate agent and lender's loan officer and the appraiser selected for a particular assignment is very limited, and in some cases, prohibited.

In institutions where the right to select appraisers has been retained, the selection is by random rotation from a list of previously qualified and board approved appraisers. Communication, thereafter, is limited to the bank officer with direct

responsibility for managing and overseeing the appraisal process. This cannot be the loan officer processing the borrower's application. Some institutions outsource the appraisal process to Appraisal Management Companies who handle the selection and oversight responsibility for the originating lender. This process helps to solidify the communication firewalls, thus reducing risks associated with regulatory compliance. However, this approach has several drawbacks that have, in some cases, caused confusion and produced less than satisfied borrower/customers.

One of the biggest criticisms of Appraisal Management Companies is that they draw on a pool of generally less experienced appraisers whose main business activity is significantly removed from the local market in which they have been chosen for an assignment.

Real estate markets, by virtue of the fixity of location, are local and require local appraisers with local experience and access to reliable local information. Assigning an appraiser from one area of a state to do a residential single-family appraisal in another area of the state, perhaps 50 miles away, makes little, if any, business or common sense. Such an assignment would render the appraisal's conclusions suspect and subject to criticism, and the possibility of having to be redone by a local appraiser. This, unfortunately, takes time and money, delays the transaction and, needless to say, makes for an unhappy customer.

The Appraisal Process

The following is a discussion of some basic concepts underlying the appraisal process, as well as forces which affect value and the methodologies used by appraisers to measure the influences those forces have on their opinions of market value.

The emphasis here will be on market value, and not other values which could be determined for a property such as going concern, use, assessed, insured or investment. These are addressed in more detail elsewhere in the course materials.

Generally, value may be considered a relationship between a thing desired and a potential purchaser.

In its very basic context, value is the desirability or worth of a thing when viewed from the perspective of the one making the acquisition. The most frequently used definition of value identifies its role in relation to an exchange that is "the quantity of one thing which can be obtained in exchange for another". This is the generally accepted definition in the appraisal profession. Value exists in the mind of the individuals. It is not inherent, but is a quality or feature ascribed to a good or service, based on how individuals consider it in relation to other goods or services which may be available.

The value which individuals are willing to ascribe to goods and services changes over time, as their personal preferences and needs change, and as surrounding environmental conditions within the marketplace change.

Value must be considered not only in the context of past or current events, conditions and information, but also on one's assessment of the future. The fact that value is forward looking based on past experience is essential to an understanding of the valuation process, particularly when value is considered in the context of the present worth of future benefits likely to be received.

It is critical to point out that value, particularly market value, is viewed <u>always</u> from the perspective of the consumer.

That is, it is the consumer who ascribes worth, not the appraiser, banker, or real estate agent. The appraiser is called upon to measure and quantify the worth ascribed to real estate assets by the consumer, while it is the banker's job in many instances to evaluate the appraiser's opinion and decide whether or not they are in agreement with regard to an asset's collateral value for loan purposes.

Real estate salespersons very often find themselves acting as intermediaries between these the appraiser and the banker when a transaction's success hangs in the balance.

However, as previously noted, the extent of their interaction is greatly limited by current and still evolving regulations. The licensed real estate and mortgage loan originators are well advised to keep abreast of the rules and follow them closely as fines and other penalties abound.

If markets were perfectly competitive, market price and market value would be equal and there would be no need for appraisers.

It is fortunate for them that this is not the case. The free workings of supply and demand would function efficiently in such a way to establish perfect equilibrium, and thus satisfy both consumers and producers at a market clearing price. Since real estate markets are imperfectly competitive, price and value may not be equal.

Market price, as previously noted, is a historical fact or artifact based on actual transactions between buyers and sellers.

Market value, on the other hand, is an opinion based on actual transactions, but rendered by an individual under a set of well-defined conditions.

The fact that market price and value might be equal is not necessarily an indication that markets are functioning more efficiently, but more likely the result of coincidence, contrivance or concessions (or some combination thereof)

Value is the market price that would tend to prevail under specified market conditions as of the appraisal/valuation date.

The "as of" date on the appraisal is absolutely essential since it establishes the contextual framework governing the appraiser's information gathering, analysis and final value reconciliation.

Without an "as of" date, it is virtually impossible for an appraiser to provide a defensible opinion of value, and renders the appraisal worthless. Value is generally measured in terms of money, a commodity which itself varies in worth over time as market conditions change. This further reinforces the need to establish an effective date of an appraisal so the relative purchasing power of the dollar (or other relevant currency) is identified clearly.

Value is a function of the productivity of a commodity such as real estate. Productivity, however, is determined by use or utility of the goods to the consumer.

This value concept is a basis for measurement of value in use, and helps to explain why the appraiser's determination of highest and best use is a critical element of every appraisal. Appraisers measure value by measuring the impact of market forces and how these forces affect typical consumers or specific users of property. They do not determine or ascribe value to properties; consumers and users of the properties do this.

The types of values which can be measured or estimated share two common observations:

a) each is a reflection of the purpose for which the measurement is undertaken
b) in one way or another, each reflects market (consumer) interactions, perceptions, attitudes and preferences.

The most important definition and type of value is market (sometimes referred to as fair market) value.
By definition, market value is the most probable price in terms of money which a property should bring in a competitive and open market under all conditions requisite to a fair sale - the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

This definition assumes that there is a consummation of a sale as of a specified date and the conveyance of title from seller to buyer under the following conditions:

a) buyer and seller are typically motivated (i.e.; typical within the context of the market in which their transaction occurs);
b) both parties are well informed or well advised and each is acting in what is considered his/her own best interest;
c) a reasonable time is allowed for exposure of the property in the open market;
d) payment is made in cash, or its equivalent;
e) financing, if any, is on terms generally available in the market at the specified or effective date; and typical for the property type and its location;
f) the price represents a normal consideration for the property sold and is unaffected by special financing amounts and/or terms, services, fees, costs; or credits incurred in the transaction.

This definition, like many others which are used by appraisers, is evolutionary and not carved in stone. It has been modified over time to reflect changing conditions in the regulatory framework of real estate finance, as well as in the context of court decisions and judicial interpretations. Further modification/evolution is not only possible, but highly probably going forward.

For goods or services to have value, they must possess certain characteristics, or be affected by certain forces that are economic in nature. These characteristics or determinants are demand, utility, scarcity and transferability. They are not mutually exclusive, that is, they all must be present to some degree to create and sustain value.

However, they may be (and usually are) present in varying degrees. The forces which influence and impact these determinants of value are constantly changing and contributing differentially to the consumer's perceptions and attitudes of relative worth.

Demand, as a determinant of value, focuses on the study of people to establish whether or not they are present in sufficient numbers with needs, wants, and the ability and willingness to pay, to justify the introduction of specific goods or services. Qualifying demand requires an understanding of changing market forces such as a city's or metropolitan area's economic growth, as well as a careful study of shifting tastes and preferences within population sub-groups which make up segments of demand.

Economic base and market analysis focus on changing forces at the macro-level that are likely to affect the quantity and distribution of demand, while the study of attitudes, preferences, life styles and opinions, and how they affect consumer behavior, is the subject of market research techniques generally categorized as psychographic testing and segmentation.

Effective demand is a function of the consumer's willingness and ability to pay for goods or services, and thus contribute or ascribe value to them. Their willingness and ability to pay is a function of the availability and cost/affordability of financing. As such, cost and availability of mortgage funds are a force which either enhances or inhibits demand. Cost and availability of funds are themselves influenced by a wide range of forces such as monetary and fiscal policy of the federal government, the creation and implementation of regulatory policies by oversight agencies, and international money market conditions which may influence the yields demanded by investors and institutional lenders for the use of their financial resources.

Utility focuses on how well the product (property) meets the needs of its intended consumers. That is, it relates directly to the benefits which the property can provide. Utility, or the functional benefits which a property can provide, changes over time as a natural function of societal trends and demographic shifts which influence consumer tastes and preference.

Likewise, utility can be enhanced or diminished by the exercise of government regulations and controls. Zoning, for example, may be changed, and thus influence the uses to which a property could be put legally. Similar use limitations could be imposed by deed restrictions or other contractual agreements which affect both current and future utilization of the property. Utility may be affected by the physical condition of properties, such as the size and shape of a vacant parcel, or the floor plan and structural integrity of building improvements.

Utility is influenced by surrounding neighborhood or environmental factors which are affected by demographic and economic changes, as well as public policy decisions to allocate public resources to enhance physical infrastructure (i.e., streets, sewer, water) or delivery of public services (i.e., schools, police and fire protection, trash collection). Public decisions which are viewed as positive by the typical consumer enhance neighborhood perceptions, and thus the utility of properties located therein.

Scarcity refers to the relative supply of properties that can meet the needs of potential buyers or tenants.

Emphasis should be placed on the concept of relative supply, that is, scarcity in relation to demand which exists within specific segments of demand (locationally, demographically, psychographically) for specific types of differentiated products or properties in given locations, of certain sizes, with certain qualities or amenities, and offering a set of property rights structured for a particular tenure.

Evaluation of relative scarcity requires a careful analysis of competitive offerings relying on the valuation principle of substitution as a guide.

It means counting and evaluating the number of substitute properties potential buyers or renters are likely to have available as alternatives from which to make their product/property selection.

Economic forces most likely to influence scarcity include the construction of new supply to satisfy the needs of a growing economy. The production of new supply, in turn, is affected by governmental policies and regulations at many levels.

At the federal level, for example, monetary, fiscal and regulatory policies influence the cost and availability of funds for developers and builders, while at the local level, infrastructure improvements, or the lack thereof, may impact the price and availability of land suitable and accessible for development. Federal or state environmental wetlands or coastal zone regulations may also influence land availability and price and, thus, relative scarcity, while local zoning and land use policies may legally restrict the quantity of land available for certain uses and thereby create scarcity.

Transferability is a determinant of value that often is overlooked in classical economic thought with respect to its contribution to value.

Imperfectly competitive real estate markets are characterized by complex transactions, if for no other reason than each is unique and subject to a wide range of legal considerations. Value is enhanced or created to the extent that the transfer of

real property rights occurs with a minimum of impediments. A salesperson's job, or at least much of it, is to minimize potential obstacles which stand in the way of a successful conveyance.

Real estate brokers and their salespersons facilitate transferability by promoting the sale/lease of property, providing information which buyers and sellers can use to make decision, assisting principals in the negotiations process, and shepherding the sale to a closing.

Economic forces, particularly those which influence income and job growth, may influence the effort that would have to be expended to promote a property, while changes in government fiscal or monetary policy may affect the ease with which a buyer can secure financing, and thus the speed with which a sale is closed.

Financing conditions can and do change very rapidly, and produce environmental impediments to the transaction over which the broker and principals exercise little, if any control.

In such cases, brokers and their salespersons may have to help the parties negotiate creative financing techniques or alternatives, which would allow the transaction to proceed. Changes in the legal environment, or discovery of legal restrictions affecting a property, may interrupt a transaction; thus adversely affect its transferability and value. This is very much the focus of the Qualifying the Title in the Mortgage Lending process.

Appraisals are done for many reasons and purposes, but fundamentally they are used to provide information that is instrumental in a pending decision (i.e.; purchase property, make a loan, settle a legal claim, etc.). In the majority of cases, the appraisal or opinion will focus on the estimate of market value (as defined) as of a given or effective date. Consequently, the approaches used and principles relied upon to estimate market value are not affected by the underlying purpose or reason for the appraisal. The focus is market value. How it is used is a decision of the party or parties for whom it was prepared.

Among the principles of market value applied to the valuation of real estate, highest and best use is the most central and fundamental to the appraisal process. By definition, a highest and best use (or the most profitable use or optimum use) is that reasonable and probably use that supports the highest present value as of the effective date of the appraisal. Alternatively, it may be considered as the most profitable likely use to which a property can be put. Implicit in these definitions is that highest and best use is the use from among competing alternative uses for a property which meets or satisfies five conditions: 1) it is physically suitable, b) it is legally permissible, c) it is appropriately supported in the market, e) it is economically and financially feasible and, e) it produces the highest residual value to the land.

Physical suitability addresses the issue of reasonableness in the context of natural and man-made physical restraints affecting the property itself and its surrounding neighborhood environment.

Factors such as the size, shape, dimensions, and subsoil characteristics of a site may impact the range or type of uses that are possible, while the general character of the surrounding neighborhood, and/or public infrastructure features which influence accessibility and proximity of area services and facilities to the subject property, may impose practical limitations on use.

The restraint of **legal permissibility** generally focuses on the uses which would be practical and allowable under both public and private restrictions. Public restrictions such as zoning and land use regulations establish a range of permissible uses within certain zoning categories or classes.

For the highest and best use determinations, zoning quickly narrows the range of possible uses to be considered unless, of course, the directive is to ignore zoning in anticipation of a change. Private deed restrictions may limit the range of permissible uses, sometimes more so than an existing zoning ordinance.

The restraint of **appropriate support** within the market focuses on the marketability of the subject property in a competitive environment influenced by forces of demand and supply, which the appraiser must analyze and evaluate.

This involves not only consideration as to how past and current market trends have affected properties similar to the subject, but more importantly, how future changes in societal/demographic trends, economic, employment and income growth, and consumer attitudes and preferences are likely to affect the absorption potential/marketability of the subject.

Careful examination and evaluation of market support is critical in reaching a valid conclusion with respect to highest and best use.

Economic and financial feasibility is a constraint which must be considered in the context of what is also market supportable. To meet the test of economic/financial feasibility, the use must be supportable at prices or rents which are

sufficient to cover capital acquisition, operating and ownership costs, while providing a market rate of return to owner/investors.

The market may support the absorption of 200 garden apartments at an average rent of $800 a month. However, if the costs necessary to produce (or acquire) and operate these 200 units dictates a rent of $1,000 per month per unit, this use would not meet the restraint of economic feasibility, and thus would not be the highest and best use of the property as of the appraisal date.

If physical suitability, legal permissibility, appropriate support and economic/financial feasibility are satisfied, then the restraint of highest residual value will be satisfied as well.

Urban development patterns are a reflection of consumer bidding activity for locations predicated upon those locations having been put to their highest and best use as a result of interacting market forces of supply and demand over time. The **principle of supply and demand** states that market value is determined by the interaction of these two forces in the appropriate market as of the appraisal date.

The appraiser must evaluate conditions and trends which are likely to influence changes in both demand and supply in the market. The appropriate market, in fact, may be at several geographic levels of consideration.

Basically, the appraiser must evaluate relevant supply/demand forces in the immediate area (neighborhood) surrounding the subject property, particularly among the types or categories of real estate that are directly competitive and represent reasonable substitutes for the subject.

However, localized neighborhood supply/demand conditions are impacted by economic and demographic trends with a larger area (i.e. city or metropolitan area). Their impact may not be as immediate as those at the neighborhood level, but they are no less important to the valuation problem. The same could be said for trends at the national and even international level, since local economies have differing degrees of interdependencies upon economic trends and conditions at these levels. The localized economic recession in oil producing states during the 1980's was more a result of international prices and supplies of oil, both of which were uncontrollable forces at local, state, or even regional levels.

*The **principles of substitution and opportunity cost** are, for the most part, reflections of each other.*

The principle of substitution, which lies at the heart of the direct sales comparison approach to value, states that consumers pay no more for a good or commodity than other consumers pay for comparable goods or commodities that are of equal utility.

Paying more than others inflicts an opportunity cost on consumers since they use more financial resources to acquire those goods, and thus forego the opportunity of acquiring more or better goods.

There is an opportunity cost involved in the expenditure of resources, because in doing so, future opportunities for potentially greater gains are foregone.

The essential point for consumers functioning in active markets is not to pay more than what others have established as value in exchange. Competitive position is evaluated on the basis of substitution, with the underlying…

… assumption that rational consumers are selecting products or properties which provide them the greatest utility price/rent levels, which minimize or eliminate opportunity cost.

The **principle of change** permeates the entire valuation process and recognizes that market dynamics are never static.

Forces in the market, such as societal/demographic trends, economic and employment conditions, government policies and surrounding environmental conditions, are subject to continuous change.

The issue for the appraiser is to identify the most important changes which are likely to impact the valuation decision, and gather and analyze information which allows for a measurement of these changes which can be reflected in the value conclusion.

The valuation conclusion, or estimate, is a forecast which reflects the appraiser's judgment with respect to how market changes are interpreted by typical consumers in their acquisition behavior.

The **principle of balance** holds that optimum market value is achieved when the agents or factors of production (i.e., land, labor, capital) and entrepreneurial expertise are in economic balance or equilibrium; i.e, they are each being adequately compensated at market terms.

Labor is receiving its market wage, capital is receiving its market interest rate, entrepreneurs are receiving their market rate of return for the level of risk they incur, and land is receiving its residual land rent market. Imbalances occur when one or more agents of production are receiving more or less than market rates of compensation.

Three related principles help to understand balance. These are the principles of contribution, variable proportions and surplus productivity (which have already been presented).
The **principle of contribution** (sometimes referred to as marginal productivity) asserts that the value of an agent of production, or a component part of a property, depends upon either how much it detracts from the value of the whole or entire property by its absence. This is a measure of the component's marginal productivity, or how much it adds to the total productivity of the property.

This principle is the basis for estimating accrued depreciation in the cost approach, due to the subject property's physical deficiencies or super adequacies (i.e., over-improvements). It is also the basis for measuring the differences between the subject property and comparable properties in the adjustment process of the direct sales comparison approach.

The **principle of variable proportions** (or increasing and decreasing returns) is a logical outgrowth of the principle of marginal productivity. Variable proportions states that when successive increments of one or more factors of production are added to fixed amounts of the other factors, income or value (measured in dollars, benefits or amenities) first increases at an increasing rate, then increases at a decreasing rate, and finally decreases absolutely.

This is an essential principle, when considering alternative use patterns and intensities of use in determining highest and best use. In such cases, land is the fixed element, and alternative improvement programs represent the variable factors. The appraiser must analyze the possible highest and best use alternatives, considering the point to which improvements can be added before dollars invested in capital expenditures receive diminishing returns—returns which do not adequately compensate production factors because they exceed what is sustainable within the market. When this occurs, the factors of production are out of balance.

The principle of **surplus productivity** states that the residual benefits generated by a property after the factors of production of labor, capital and entrepreneurial expertise are compensated at market rates, the residual accrues to the underlying land.

Economists refer to this residual income as land rent, and it is the basis upon which location decisions are made and land development patterns emerge.

Urban development patterns are a reflection of consumer bidding activity for locations predicated upon those locations having been put to their highest and best use as a result of interacting market forces of supply and demand over time.

Externalities are not a principle, but an economic concept that identifies factors outside of the subject property itself which affect the subject's value.

Externalities are generally considered in the context of the appraiser's neighborhood analysis, and may have either positive or negative effects on the subject property's value. The effects of individual externalities are difficult to measure in terms of their contribution to or detraction from the value of the subject property.

Externalities are considered in groups or categories with regard to their impact on the overall neighborhood environment, and may include features such as schools, churches, recreation facilities, employment and shopping locations, which generally contribute positively to values.

Negative externalities may include intrusive or nuisance land uses which create noise, pollution or other inconveniences, as well as major new developments which place additional burden on the public infrastructure, and thus compete with existing properties for adequate services.

The public sector typically uses its police powers to create and enforce regulations designed to minimize the impact of negative externalities on the public or community at large. At minimum, this includes zoning and land use planning guidelines, the levy of impact fees, and other required direct compensation from those create negative externalities. Like most everything else in freely functioning markets, externalities are subject to change for better or worse.
Appraisers must take into consideration all of these principles as they apply to three approaches or methodologies used to arrive as indications of market value.

Each approach or method is relatively straight forward and contains fairly few steps. Although USPAP standards call for using all three approaches, the appraiser is able to make exceptions, as long as the reasoning for the exception is based on defensible facts or conditions.

The **Direct Sales Comparison Approach** is grounded in the principle of substitution, and most frequently is used in valuations of vacant land, single-family residences and condominiums or townhouses.

It relies heavily on the availability of a sufficient quantity of recent transactions in the marketplace that best reflect consumer behavior with respect to properties comparable to the subject. The steps of the approach are straight forward and logical if one understands the principles of substitution and contribution.

As in all approaches, it is assumed that the appraiser has completed a thorough inspection of the property and has identified those features which typical consumers consider in evaluating the subject and properties that are reasonable alternatives.

The inspection and gathering of other property specific information helps the appraiser establish basic descriptive criteria that will be used to compare the subject with comparables selected which share many of the same features and qualities.

Since no two parcels of real estate are exactly alike, if for no other reason than uniqueness of location, comparables chosen for the analysis are not perfect substitutes for the subject. To apply the technique and minimize the influence of consumer opportunity cost when selecting between the subject and comparables, the comparables must be subjected to an adjustment process relying on evidence from the market to measure the contribution of differing features.

Adjustments are made from comparables to the subject. That is, the subject is considered base 100 and either positive or negative dollar or percentage adjustments are made for features which differ from the subject.

The objective of the adjustment process is to mathematically create perfect substitutes to the subject; that is, bring all the comparables (at least on paper) to base 100. The plus and minus dollar adjustments are made to the verified selling price of the comparables and summed to determine value for the subject.

The adjustments typically proceed in the following sequence:

a) Terms and conditions of financing
b) Market-to-market or for the date/time of sales
c) Comparable property to the subject property for features such as size, location, condition and amenities.

Tools used to measure or quantify the value of the adjustments include paired sales analysis, sequential analysis, regression analysis, and depreciated costs. Paired sales analysis is particularly useful in measuring the contribution of differing features based on an analysis of pairs of past transactions, which isolate on price deviations attributed solely to the presence or absence of a particular feature. This technique may also be used to quantify price differences (i.e., contributory value) for location variations, as well as variations in financing terms and conditions of the sale. However, for most financing adjustments, appraisers rely on mathematical techniques employing present value or discounting concepts.

Market-to-market adjustments to account for the passage of time since the date the comparables sold can be quantified using either a sequential or regression analysis. Both focus on measuring rates of change in price over time, based on a sampling of actual transactions drawn from the relevant market area. Although generally more accurate and reliable, regression analysis, by design, is a mathematical modeling technique that requires relatively large quantities of data. For most appraisers, the technique may be cumbersome and difficult to use. Reliance on a less data demanding technique like sequential analysis provides useful and reasonably accurate information for making time adjustments. The appraisers may also rely on information and analysis provided by local sources, which periodically track price and rent trends for the market area as a whole, as well as for individual neighborhoods.

Cost Approach is also grounded in the principle of substitution, in that it is based on the premise that a typically informed consumer pays no more for a property than it would cost to acquire a site comparably located and build new improvements of equivalent utility to the subject (less a charge for actual depreciation).

Although the cost approach may be used in valuing almost all types of real estate, it is particularly applicable in appraising special use properties such as churches, school buildings, government buildings, and hospitals.

It is applicable for appraising newly constructed properties where there has been little or no accrued depreciation, as well as valuing proposed construction. The cost approach is also most useful when the direct sales comparison and income approaches cannot be applied for lack of sufficient information due to market inactivity.

The cost approach is deceptively simple because of the relatively few steps involved in the process. The approach rests on the principle that consumers pay no more for the property than it would cost to assemble a comparable set of factors.

The appraisal process focuses first on estimating the value of the site underlying the improvements as vacant and available for development in its highest and best use.

The appraiser relies on the direct sales comparison approach to do this, selecting sites comparable to the subject in terms of location, size (frontage and depth), topographical features, subsoil conditions, and other natural features. Adjustments for deviations from the subject as base 100 are made in a similar manner, as previously discussed with plus and minus dollar, or percentage adjustments substantiated by market evidence.

The balance of the cost approach focuses on the improvements: estimating the replacement cost new, and deducting market derived measures of diminished utility (accrued depreciation) caused by physical depreciation, functional and locational/economic obsolescence.

The appraisal process usually requires estimating the replacement cost new of the improvements.

Replacement cost is the cost of constructing a new building at current prices, having utility equivalent to the building being appraised, but built with modern materials and according to current standards, design and layout.

Once the replacement cost new of structures and site improvements have been estimated, the appraiser then estimates accrued depreciation caused by the passage of time and use of the building.

Depreciation in the appraisal process is viewed as actually occurring as a result of physical deterioration, or wear and tear, functional obsolescence (diminished utility), and locational/economic obsolescence (i.e., value diminished by externalities).

Physical and functional depreciation may be either curable or incurable, while locational or economic obsolescence is, by definition, always incurable.

The test of curability is purely economic and relates to the principles of contribution and marginal productivity. An item of depreciation is curable if the cost to bring about the cure (i.e., repair or remediation) is less than, or equal to the incremental increase in value that will be credited or ascribed to the property in the marketplace. An item is incurable if the cost to cure is greater than the incremental increase in value, which may result from the capital expenditure.

In other words, costs expended to cure items of accrued depreciation must be compensated by the marketplace by generating increasing returns, as measured by marginal gains in value. If the value increase is less than the cost to cure, the item of depreciation is incurable.

The cost to cure negative externalities cannot be borne by any individual property, and must meet the test of curability. Curing negative externalities usually is a function of the public sector, which may be encouraged to do so by individual property owners/consumers. As a result of such actions, the remediation of negative externalities may have a cumulative effect on properties over time, and thus cure or at least mitigate some locational obsolescence.

> Physical depreciation, or deterioration, occurs over time due to normal wear and tear inflicted on improvements by users and the forces of nature. Functional obsolescence occurs over time, but it is the result of changing consumer tastes and preferences and changes in technology, which affect construction methods and standards, as well as equipment, fixtures and amenities installed. Design standards which affect features such as floor plans and internal traffic patterns change in response to societal, demographic and economic trends. The degree to which existing improvements deviate from current market preferences for such standards is reflected in functional obsolescence.

The appraiser adds the depreciated value of buildings and site improvements to the estimated value of the site as if vacant, and puts it to its highest and best use to arrive at an indication of value by the cost approach.

In many cases, depending on market conditions, this indication of value will be higher than the estimate derived from the direct sales comparison approach and also by the income approach, which is discussed next.

The **Income Approach** focuses on measuring the present worth of a flow of future benefits (expressed as income) which the owner expects to receive.

Value estimates are derived by capitalizing or discounting a projected income stream at an interest rate which reflects how other market participants have discounted or valued income streams received from properties comparable to the subject.

As its name implies, it is an approach best suited to valuing income producing properties. It is the approach which typically receives the greatest weight when conclusions regarding a reconciled final value for income producing real estate are considered.

Variants of the income approach include the Gross Income Multiplier (GIM) and Gross Rent Income Multiplier (GRM) approaches.

The **GIM approach** is generally applicable in the valuation of large income properties, and focuses on the relationship between gross income received for a property and a multiple of this annual income which a buyer/investor actually paid.

Although sometimes confused with the income approach, GIM focuses on gross annual income received, while in the income approach, the focus is on Net Operating Income (NOI). As such, the income approach not only considers the effect of market rents on value, but also the efficiency of management in a competitive market environment as reflected by operating expenses incurred. The GIM approach is more akin to a comparative sales approach to value, since it derives multiples based on what buyers were willing to spend for a flow of rental income, which reflect amenity values ascribed to the property by tenants irrespective of management and operational controls which directly influence profitability.

The Gross Rent Multiplier (GRM) approach is based on a similar premise, and is used in valuing single-family homes and small residential income properties such as duplexes, threeplexes or fourplexes.

Instead of annual income, the GRM Approach considers the relationship between gross monthly rents and price. It, too, is a method more akin to a comparative sales approach for the same reasons stated above.
Steps in the income approach are also fairly straightforward. Since the focus is on market value, the appraiser must rely on market rents as a basis for forecasting a stream of income for the subject property.

Market rents must be drawn from comparable properties and adjusted for deviations (i.e., location, quality, amenities, utility payment policy, etc.) in much the same fashion as the adjustment process for direct sales comparison and land valuation.

For example, an appraisal of a small income producing property, such as a duplex or fourplex, would require the appraiser to extract current monthly market rents from a sample of properties considered comparable to the subject.

Second, the appraiser would have to extract sales of comparable income producing to determine a market supportable GRM.

This would be determined by dividing the verified sales price by the gross monthly rents collected at the time of sale. Several indications of such sales would be needed to drive an overall GRM for the market area/neighborhood relevant to the subject property. To arrive at an estimate of market value, the appraiser would multiply the estimated market rent for the property by the GRM.

***Reconciliation** is the final step in the appraisal process, and is perhaps the most important element of an appraisal.*

By definition, reconciliation is the process by which the appraiser evaluates, chooses, and selects from among alternative indications generated by each approach used to reach a single final value conclusion.

The fact that it is defined as a process implies a systematic review of the entire appraisal process to identify mistakes, miscalculations or oversights that may affect the appraiser's final value conclusion. It is the process of asking questions regarding the accuracy of mathematical calculations, the appropriateness and applicability of the data used, and the consistency of the logic employed by the appraiser in applying the methodologies and underlying principles of real property valuation.

It is not, and this should be stressed, a matter of simply averaging the two or three value indications derived into a single value conclusion.

Averaging, aside from being illogical, violates the fundamental principles underlying the appraisal process and treats each value indication equally. If each value indication was weighted equally, the appraiser would be reaching the highly unlikely conclusion that everything used to arrive at these indications was equivalent in terms of both quantity and quality. Given the highly imperfect character of real estate markets, such a conclusion defies not only the laws of chance, but also basic common sense.

The appraiser may, in fact, apply different weights or probabilities to each value indication, and then calculate a weighted average which is reconciled as a final value estimate.

However, the assignment of the weights is the result of reasoned judgment following careful review of the entire appraisal process. Anything other than this which passes itself off as reconciliation will result in useless and meaningless value conclusions.

Almost anyone can be trained to do the mechanics of appraisal; reconciliation is learned through experience.

The four remaining elements of the Mortgage Lending process will continue in the next part of this program.

Lesson Summary

Loan underwriting

- Loan qualification is a component of the overall loan application process, and includes not only consideration of the value of the collateral pledged as security, as well as the creditworthiness of the borrower(s).

Loan application

- The lender uses the loan application and review procedures to gather information regarding the property and the borrower to evaluate the potential risks associated with making the loan.

Credit scores

- The applicant's credit scores will be retrieved and evaluated within the framework of the loan for which the borrower is applying.

Credit analysis

- In evaluating the borrower, the lender is attempting to assess the four "C's" of credit analysis: credit history, character, capacity to repay and collateral value.

Five major elements of Mortgage Lending

- Qualifying the property, qualifying the title, closing, servicing the loan and qualifying the borrower.

Establishing Fair Market Value

- The appraisal is focused on establishing a Fair Market Value for loan purposes.
- The inspections are to verify the collateral's condition and corroborate disclosures made by the current owners/sellers.

The appraiser

- Must adhere closely to the Uniform Standards of Professional Appraisal Practice (USPAP)
- The appraiser is rendering his or her opinion of value.
- Direct communication between the property owner, real estate agent, lender's loan officer and the appraiser is very limited, and in some cases, prohibited.

The appraisal process

- The emphasis is on market value.
- Value may be considered a relationship between a thing desired and a potential purchaser.
- Value which individuals are willing to ascribe to goods and services changes over time.
- Market value is viewed always from the perspective of the consumer.
- Real estate salespersons often act as intermediaries between the appraiser and the banker.

Market price

- A historical fact or artifact based on actual transactions between buyers and sellers.

Market value

- An opinion based on actual transactions, but rendered by an individual under a set of well-defined conditions.

- The most probable price in terms of money which a property should bring in a competitive and open market under all conditions requisite to a fair sale.
- Assumes a consummation of a sale as of a specified date and the conveyance of title from seller to buyer under the following conditions:
    - Buyer and seller are typically motivated
    - Both parties are well informed or well advised and each is acting in what is considered his/her own best interest;
    - A reasonable time is allowed for exposure of the property in the open market;
    - Payment is made in cash, or its equivalent;
    - Financing, if any, is on terms generally available in the market at the specified or effective date; and typical for the property type and its location; and
    - The price represents a normal consideration for the property sold and is unaffected by special financing amounts and/or terms, services, fees, costs; or credits incurred in the transaction.

"As of" date
- Establishes the contextual framework governing the appraiser's information gathering, analysis and final value reconciliation.

Value measurement and estimations
- Each is a reflection of the purpose for which the measurement is undertaken.
- In one way or another, each reflects market (consumer) interactions, perceptions, attitudes and preferences.
- The most important definition and type of value is market (sometimes referred to as fair market) value.

Value characteristics
- For goods or services to have value, they must possess certain characteristics, or be affected by certain forces that are economic in nature. These characteristics or determinants are demand, utility, scarcity and transferability.

Demand
- Focuses on the study of people to establish whether or not they are present in sufficient numbers with needs, wants, and the ability and willingness to pay, to justify the introduction of specific goods or services.
- Economic base and market analysis focus on changing forces at the macro-level that are likely to affect the quantity and distribution of demand.

Utility
- Focuses on how well the product (property) meets the needs of its intended consumers as it relates directly to the benefits which the property can provide.
- Utility is influenced by surrounding neighborhood or environmental factors which are affected by demographic and economic changes

Scarcity
- Refers to the relative supply of properties that can meet the needs of potential buyers or tenants.
- Economic forces most likely to influence scarcity include the construction of new supply to satisfy the needs of a growing economy.

Transferability
- Real estate brokers and their salespersons facilitate transferability by promoting the sale/lease of property, providing information which buyers and sellers can use to make decision, assisting principals in the negotiations process, and shepherding the sale to a closing.

Physical suitability
- Addresses the issue of reasonableness in the context of natural and man-made physical restraints affecting the property itself and its surrounding neighborhood environment.
- Factors such as the size, shape, dimensions, and subsoil characteristics of a site may impact the range or type of uses that are possible, while the general character of the surrounding neighborhood, and/or public infrastructure features.

Legal permissibility
- Focuses on practical and allowable uses under both public and private restrictions. Public restrictions such as zoning and land use regulations establish a range of permissible uses within certain zoning categories or classes.

- Private deed restrictions may limit the range of permissible uses, sometimes more so than an existing zoning ordinance.

Appropriate support
- Focuses on the marketability of the subject property in a competitive environment influenced by forces of demand and supply, which the appraiser must analyze and evaluate.

Economic & financial feasibility
- The use must be supportable at prices or rents sufficient to cover capital acquisition, operating and ownership costs, while providing a market rate of return to owner and/or investors.

Supply and demand
- Market value is determined by the interaction of these two forces in the appropriate market as of the appraisal date.
- The appraiser must evaluate relevant supply/demand forces in the immediate area surrounding the subject property, particularly among directly competitive and reasonable substitutes for the property.

Principle of substitution
- States that consumers pay no more for a good or commodity than other consumers pay for comparable goods or commodities that are of equal utility.

Opportunity cost
- The expenditure of resources where future opportunities for potentially greater gains are foregone.

Principle of change
- Permeates the entire valuation process and recognizes that market dynamics are never static.
- The issue for the appraiser is to identify the most important changes which are likely to impact the valuation decision.

Principles of balance
- Holds that optimum market value is achieved when the agents or factors of production and entrepreneurial expertise are in economic balance or equilibrium.
    - Principles of contribution
    - Variable proportions
    - Surplus productivity

Principle of contribution
- The value of an agent of production, or a component part of a property, depends upon either how much it detracts from the value of the whole or entire property by its absence. This is a measure of the component's marginal productivity, or how much it adds to the total productivity of the property.

Principle of variable proportions
- A logical outgrowth of the principle of marginal productivity. Variable proportions states that when successive increments of one or more factors of production are added to fixed amounts of the other factors, income or value (measured in dollars, benefits or amenities) first increases at an increasing rate, then increases at a decreasing rate, and finally decreases absolutely.

Principle of surplus productivity
- The residual benefits generated by a property after the factors of production of labor, capital and entrepreneurial expertise are compensated at market rates, the residual accrues to the underlying land.
- Economists refer to this residual income as land rent, and it is the basis upon which location decisions are made and land development patterns emerge.

Externalities
- An economic concept that identifies factors outside of the subject property itself which affect the subject's value.
- Externalities are considered in groups or categories with regard to their impact on the overall neighborhood environment, and may include features such as schools, churches, recreation facilities, employment and shopping locations, which generally contribute positively to values.
- Negative externalities may include intrusive or nuisance land uses which create noise, pollution or other inconveniences, as well as major new developments which place additional burden on the public infrastructure, and thus compete with existing properties for adequate services.

Approaches to Value Determination

- USPAP standards call for using three approaches to determine fair market value. The appraiser is able to make exceptions, as long as the reasoning for the exception is based on defensible facts or conditions. These approaches are:
- Direct Sales Comparison, Cost Approach and Income Approach
    - Direct Sales Comparison
        - Grounded in the principle of substitution, and most frequently is used in valuations of vacant land, single-family residences and condominiums or townhouses.
        - It is assumed that the appraiser has completed a thorough inspection of the property and has identified those features which typical consumers consider in evaluating the subject and properties that are reasonable alternatives.
        - The subject is considered base 100 and either positive or negative dollar or percentage adjustments are made for features which differ from the subject.
        - The adjustments typically proceed in the following sequence:
            - Terms and conditions of financing
            - Market-to-market or for the date/time of sales
            - Comparable property to the subject property for features such as size, location, condition and amenities.
    - Cost Approach
        - Also grounded in the principle of substitution, in that it is based on the premise that a typically informed consumer pays no more for a property than it would cost to acquire a site comparably located and build new improvements of equivalent utility to the subject.
        - The cost approach may be used in valuing almost all types of real estate, but is best for appraising special use properties such as churches, schools, government buildings, and hospitals.
        - The appraisal process focuses first on estimating the value of the site underlying the improvements as vacant and available for development in its highest and best use.
        - The balance of the cost approach focuses on the improvements: estimating the replacement cost new, and deducting market derived measures of diminished utility (accrued depreciation) caused by physical depreciation, functional and locational/economic obsolescence.
        - Replacement cost is the cost of constructing a new building at current prices, having utility equivalent to the building being appraised, but built with modern materials and according to current standards, design and layout.
        - Depreciation in the appraisal process is viewed as actually occurring as a result of physical deterioration, or wear and tear, functional obsolescence, and locational/economic obsolescence.
        - Physical and functional depreciation may be either curable or incurable, while locational or economic obsolescence is always incurable.
        - Depreciation in the appraisal process is viewed as actually occurring as a result of physical deterioration, or wear and tear, functional obsolescence, and locational/economic obsolescence.
        - Costs expended to cure items of accrued depreciation must be compensated by the marketplace by generating increasing returns.
    - Income Approach
        - Focuses on measuring the present worth of a flow of future benefits (income) which the owner expects to receive.
        - This approach is best suited to valuing income producing properties.
        - Variants of the income approach include the Gross Income Multiplier (GIM) and Gross Rent Income Multiplier (GRM) approaches.
        - The GIM approach is generally applicable in the valuation of large income properties, and focuses on the relationship between gross income received for a property and a multiple of this annual income which a buyer/investor actually paid.
        - The GRM approach is based on a similar premise, and is used in valuing single-family homes and small residential income properties such as duplexes, three-plexes or four-plexes.
        - Since the focus is on market value, the appraiser must rely on market rents as a basis for forecasting a stream of income for the subject property.

Reconciliation

- The process by which the appraiser evaluates, chooses, and selects from among alternative indications generated by each approach used to reach a single final value conclusion.
- It is not a matter of simply averaging the two or three value indications derived into a single value conclusion.

- The appraiser may apply different weights to each value indication, and calculate a weighted average which is reconciled as a final value estimate.

Overview

- Qualifying the Title
- Closing
- Servicing the Loan
- Qualifying the Borrower
- Conforming Conventional Loan
- Qualification Guidelines
  - Fixed Obligations or
  - Back End Ratio
- Conforming Government Insured Non-Conventional Loans
  - Maximum Loan Limits
  - Minimum Required Down Payment for
  - FHA 203(b) Loans
  - Income Qualification Ratios
  - Compensating Factors
  - A Mortgage Insurance Premium (MIP)
- Conforming Government Guaranteed Non-Conventional Loans
  - The VA Guarantee or Entitlement
  - Eligibility for VA Loans
  - Certificate of Eligibility
  - Qualifying Ratio for VA Loans
  - Funding Fee
  - Seller Contributions
  - Assumption of VA Loans
  - Certificate of Reasonable Value

Qualifying the title is largely a matter of assessing and securing assurances regarding the veracity and accuracy of the title rights associated with the real property being accepted as collateral by the lender/mortgagee.

This is a part of the process which relies heavily on the expertise of those who know how to thoroughly search property records, identify potential defects or title deficiencies, and determine one or more courses of legal action necessary to address and remediate these issues. Attorneys, abstractors, and title companies are the parties who are important to ensuring the veracity and authenticity of title rights acquired by purchasers and taken as security by lenders.

The recordation of written documents regarding real estate transactions provides the most complete resource possible for examining, verifying and authenticating the quality of title being transferred, or taken as collateral.

Most jurisdictions have well organized systems for accessing and using property records; thus researching title quality can be done relatively fast and inexpensively.

The legal record of transactions is open to the public, and is often the basis for monitoring local real estate sales trends in addition to fulfilling the needs of those who must study and evaluate the credibility and genuineness of title for a parcel of real estate. In essence, recordation provides what is known as constructive notice for all transactions and legal actions that directly affect title rights to real property. As such, this record allows one to conduct a chain of title search to trace a property's ownership history, as well as a history of claims (i.e., liens) and other legal actions which may have entered the chain over a period of time.

The development and maintenance of recording systems, along with the introduction of information technology, allows for the efficient and relative rapid research of the historical record of property ownership. These historical reports are called abstracts of title, and recite a complete summary of all recorded documents affecting title to property.

It lists, in chronological order, all recorded grants and conveyances, as well as recorded easements, mortgages, wills, tax liens, judgments, pending lawsuits, marriages, divorces and other contracts that might affect title. The abstracter will note any and all recorded claims that create clouds on the title (i.e., create uncertainty with respect to its genuineness and marketability) and include a list of public records searched and not searched in preparing the abstract.

The abstract is then delivered to an attorney who examines the title evidence, and renders an opinion with regard to its quality and possible remedies for defects which have been identified.

The attorney's opinion identifies the fee owner, and names anyone else with a legitimate right or interest in the property. This opinion, when written, signed by the attorney, and attached to the abstract, in many states, is referred to as a certificate of title and, by itself, is an acceptable authentication of the title rights and their quality and authenticity. In most closings, the attorney or title agent representing the lender will assume primary responsibility for title verification.

However, even with the best efforts of the abstracters and the expertise of the attorneys, there are no guarantees that the completed abstract is completely accurate. Persons preparing abstracts and opinions are liable for mistakes due to their own negligence, and they may be held financially accountable for resulting damages.

There are, however, numerous situations or conditions which may render the chain of title, the abstract and certification deficient, through no fault of those preparing them. Defects in the recordation system, clerical mistakes, recordation of invalid deeds, contracts, liens, misfiling of documents, erroneous property description, or any number of conditions could adversely affect the record, and thus create future liabilities regarding the genuineness of marketability of title.

Recognizing the possibility of such defects, private companies have been organized to sell insurance to indemnify property owners and lenders against losses arising from title deficiencies, such as those listed above, as well as from errors in title examination.

Title insurance is not a recent concept in real estate, in that attorneys have acquired such insurance since the late 1800's to protect themselves against liability for rendering erroneous interpretations of title abstracts. Title insurance is readily available for anyone wishing to purchase it and, very often, is required in many real estate transactions to protect both the buyer and the mortgagee if borrowed funds are involved. Very often, the title policies are available from the attorneys who review the abstract and render an opinion, although independent title companies are available in most areas.

Title insurance policies can be written to protect both the owners (mortgagors) and lenders (mortgagees).

Although both policies focus on protecting against loss due to future claims against the title by third parties, there are important distinctions which should be stressed. First, the owner's policy includes coverage for the total sale price of the property for as long as the insured or insured's heirs have a legal interest in the property. In contrast, the lender's policy covers the amount outstanding on the loan, which should be declining depending, of course, on the type of instrument used (i.e., fully amortized versus ARM or GPM with negative amortization). The lender's policy terminates when the mortgage is fully repaid. Second, the lender's policy does not make exceptions for claims to ownership that could have been determined by physically inspecting the property while the owner's policy would, except such claims. Third, the lender's policy is assignable to subsequent holders of the same loan, while an owner's is not. Without this provision for lender policies, resale of loans in the secondary market would be limited.
Closing the loan transaction may or may not involve a transfer of title, although it very often does.

In cases of loan refinancing, there is no conveyance of title, but there is usually the need to verify title rights and, in some cases, reissue title insurance policies.

This discussion assumes a loan closing where title rights are being conveyed.

Also, there are generally two types of closings conducted, depending largely on local custom and practice in each state.

- The face-to-face, or **personal closing**, is one in which all (or most) of the parties to the transaction appear physically before a closing attorney, title agent or notary in a room (typically a closing attorney's or title company's conference room), to sign and exchange documents and to receive disbursements or make payments as called for to complete the transaction. In the event one or more partners cannot be physically present, they can assign their power of attorney to another party who will carry out their specified directions so the closing can be completed.

- The alternative to a fact-to-face closing is an **Escrow closing**, where neither party nor their representatives are required to be physically present to complete the transaction.

The escrow closing is common in many states, and is based upon buyer and seller agreeing to secure the services of an Escrow Agent to represent both, and perform all duties and responsibilities necessary to successfully complete the transaction.

Both parties sign an escrow agreement, which details the obligations for which all parties are responsible and provides sufficient instruction to the closing agent so that steps can be taken, which will culminate as quickly and efficiently as possible. Like most real estate contracts, time is of the essence, and the escrow agreement typically includes dates or timeframes in which certain elements of the agreement have to be satisfied and appropriate documents need to be signed and delivered to the agent.

Escrow agents must be disinterested third parties who are compensated for their time and effort, and not based upon the value of the transaction.

As such, in states allowing licensed real estate brokers to serve as escrow agents, they are prohibited from having a commission interest in the transaction. More commonly, escrow agents are attorneys, notaries or individuals working for title companies who are properly credentialed, licensed or certified.

Among other things, escrow agents coordinate all closing related activities including, but not necessarily limited to, scheduling the closing date, ordering title examination and title policy insurance, collecting all necessary documents, collecting deposits, disbursing payments, and recording documents such as the deed and mortgage.

The closing, or settlement as it is often labeled, is the culmination of much work and effort by a number of different people to bring the real estate transaction to a successful completion. The speed and efficiency with which the closing occurs is a direct reflection of how well the various participants perform their duties and responsibilities. It is in the best interest of real estate salespersons, real estate brokers and mortgage loan originators for this transaction to occur as efficiently and quickly as possible. This ensures payment of commissions due, enhances the element of property transferability, and produces a satisfied client. Unforeseen delays, disagreements and discord among the participants at a closing, is a fair indication that one or more of the parties in the process failed to perform as expected and could jeopardize the entire transaction.

The process begins when the purchase agreement is signed and ends typically 30 to 60 days later at the closing.

The purchase agreement identifies the responsibilities of both buyer and seller to achieve a successful title closing. At the closing, documents are exchanged and signed, computations are checked to ensure correct disbursements to all parties, and checks are written accordingly.

There probably is no such thing as a perfect closing, but the next best thing is one that is finished. A finished closing marks the end of a successful transfer of title and securing of credit to facilitate the transaction.

However, to be successful, each of the involved parties, including the seller, buyer, lender, attorney, broker and escrow agent (title company), if different from the attorney, are responsible for completing various tasks.

The duties of the buyer and seller should be clearly recited in the purchase agreement. This contract identifies tasks or responsibilities that must be performed by each party, and possibly others as a prerequisite to achieving a successful closing. Failure to perform in good faith, as agreed, constitutes default or breach of contract for which aggrieved parties may seek a monetary award for damages or specific performance of the agreement.

Complaints regarding violations of RESPA are filed with the HUD Office of Consumer Affairs for remedies regarding unfair practices involving referral fees and mandatory purchases of title insurance.

If violations can be proven, claimants may receive triple damages on the amount of fees or premiums paid, plus attorney's fees and court costs. Criminal penalties may also be pursued. However, this requires the concurrence of the Secretary of HUD and the U.S. Attorney's office, based upon the preponderance of evidence supplied by claimants through the Office of Consumer Affairs.

Criminal and severe civil penalties are usually pursued by the Department of Justice (DOJ) when patterns of abuse and noncompliance appear to be widespread, intentional, or malicious. Such actions by the DOJ are relatively rare, but can be very costly for those targeted for enforcement action.

Servicing the loan is largely a behind the scene activity which is invisible to most borrowers.

For some borrowers, however, it is an important matter, since their preference would be to do business with lenders who retain and service the loans they originate, rather than sell them to investors in the secondary mortgage market.

In essence, there are three basic options governing the loan servicing process. These options can be summarized as follows:

- Originate, Hold and Service;
- Originate, Sell and Service; or
- Originate, Sell and Service Release.

The Originate, Hold and Service Option is one practiced by many lenders who have limited secondary market experience, or who originate mostly nonconforming loans tailored to the individual needs of their local customers.

This would not be an uncommon pattern for community banks with strong deposit and net worth positions serving customers, particularly in small towns and rural communities.

Although they may originate loans in conformance with secondary market standards, they book them as assets and retain them in their loan portfolio.

In doing so, they may charge borrowers a slight interest rate premium for keeping the loan and assuring the customer that it will be serviced locally. The slight premium may be warranted to help offset some interest rate risk and may also be accompanied by a loan structure which offers a long term amortization period, but shorter terms. The renegotiable rate mortgage previously discussed is an example of this type loan structure.

In this originate and hold arrangement, loan payments are sent to the local lender, where principal and interest payments and escrows are credited to the customer's account.

Payments for property taxes and casualty insurance premiums are disbursed.

The Originate, Sell and Service Option is similar to the first in that customer's primary contact for matters regarding the loan is the originating bank or savings association.

In this scenario, the institution originates the loan in conformance with secondary market standards with the intent of delivering it either shortly after closing, or at a time when interest rate movements are most favorable to making a profit on the sale of the loan.

However, although the loan is sold, the originating lender retains servicing rights, and the direct relationship with the borrower is maintained.

Payments are sent to the originating lender who collects a fee (usually 3/8 of 1%) and forwards the principal and interest payments to the investor or its designated agent. The local lender continues to manage the escrows for taxes and insurance and disburses payments when they are due.

The arrangement to originate, sell the loan, but retain the servicing, is among the disclosures the lender must make to the borrower at the closing, if not beforehand.

The Originate, Sell and Service Release Option, in many instances, is the least preferred by borrowers, since once the loan is sold, the originating institution is largely out of the picture.

In this scenario, local institutions originate conforming loans, deliver them to the secondary market, and release servicing to a third party.

The third party, who is acting on behalf of the loan investors, is then responsible for collecting payments, forwarding principal and interest payments to the investors or their agents, managing escrow accounts for taxes and insurance, and making disbursements at the appropriate time.

For these services, the third party collects a fee. This arrangement is also subject to full disclosure by the lender to the borrower at, or before, closing.

Qualifying the borrower is an important initial step in the loan origination process that follows a series of steps focused largely on determining how much the borrower can afford to borrow, and how much the lender can expect to lend with a reliably measured prospect of being paid back.

It is very much a "dating game" between the parties, attempting to see how far each is willing to go in the relationship. It is also a very important reality check for everyone involved in the transaction that is best addressed sooner, rather than later. For example, it is far better for a real estate agent to understand the borrowing capacity and, thus buying power a prospective purchaser may possess, before embarking on the house search process.

This is a good way to minimize disappointment, streamline the search, and avoid wasting valuable time and effort. Although borrower qualification is usually associated with institutional lending, those entering into some form of owner financing outside the institutional framework might very well be advised to at least perform a cursory income qualification test on the party to whom credit is being extended. Understandably, this will not involve all of the disclosures required of applicants in many institutional settings, but it is a safeguard that can help identify, measure, and minimize potential problems going forward.

The property search process can usually be accelerated and made more efficient if the prospective purchaser has been pre-qualified or pre-approved by a lender, with the latter being most preferred.

The pre-qualification process typically means the applicant has provided basic information with which to ascertain income at a level sufficient to qualify for a loan up to a certain level, or within a given range.

In the pre-qualification process, the lender does not typically require verification of employment, nor does it order a credit report or conduct a review of assets and liabilities of the prospective borrower.

A pre-approval letter from a lender is a significantly stronger statement of credit worthiness of the prospective borrower/purchaser…

…and thus a more significant statement regarding total buying power available to complete a transaction, and to do so more quickly since the requirement to secure financing has largely been satisfied. This gives buyers bargaining power, and sellers an incentive to accept terms that might accomplish their goals in a significantly shorter period of time.

The issuance of a pre-approval letter typically means the lender has completed all the steps encompassed within a pre-qualifying process, while also having reviewed credit reports, verification of employment, and the applicant's assets and liabilities.

In most cases, final loan approval will be subject to receipt of an appraisal and final review of additional documents that may be required to verify employment and income history, and the amount and type of liquid assets which the applicant has available.

To evaluate affordability or capacity, the lenders rely on underwriting guidelines established for conventional loans which conform to secondary market agency requirements of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), or Fannie and Freddie.

These are standardized guidelines which borrowers must satisfy to qualify under the terms of the loan requested in conformity with expectations of secondary market investors and assurances provided by Fannie and Freddie. As previously discussed, this conformity and uniformity is what gives investors a comfort level to treat the mortgage backed investments they acquire the same as they would any other security placed in their portfolio. Uniform income qualification standards help to mitigate, although not eliminate, default risk for investors and assure them of an income stream to generate their targeted yields.

In addition to conventional loan income qualification guidelines, **agencies such as the FHA and VA utilize their own criteria for underwriting capacity risk** *for loans that are originated by private lenders, but insured or guaranteed by them. Similar to Fannie and Freddie criteria, these guidelines of uniformity and conformity provide similar assurances for secondary market investors against default risk.*

Conforming Conventional Loan Qualification Guidelines focuses on using two financial ratios to measure affordability, or payment capacity risk, as it is sometimes called. The two ratios are the Mortgage Debt Service, or Front End Ratio, and the Fixed Obligations, or Back End Ratio.

The Front End considers the financial obligations directly associated with the loan and property acquisition in relation to the gross income of the borrower(s).

More specifically, the ratio considers the monthly cost for principle and interest payments (debt service), plus monthly escrows for property taxes and property and casualty insurance.

To qualify under the criteria, the Front End Ratio must not exceed 28 percent of gross monthly income for fixed rate, level payment loans, or 25 percent for adjustable rate loans under the predominant loan underwriting standards currently in use. These ratio criteria may change in relation to cost and availability of funds.

However, the components of the formula do not change unless the loan applicant is acquiring a condominium or property located in a community governed by a homeowners association. In these instances, the condominium association, or homeowner's association monthly fee, is added to the monthly financial obligations directly associated with the purchase of the property, and the resulting ratio must remain within accepted guidelines. The ratio may also be affected by the existence of a Private mortgage Insurance (PMI) premium payment.

Private Mortgage Insurance, offered by private companies such as Mortgage Guaranty Insurance Corporation (MGIC), covers the top portion of loans exceeding the standard LTV ratio.

The policies are designed to protect the originating lenders and investors in the event of default, but the premiums are paid by the borrower.

PMI makes it possible to originate highly leveraged loans that would otherwise only be available through either FHA or VA loans. As such, they give buyers/borrowers more purchasing power when searching for a home.

Premium payments are calculated as a percentage of the outstanding loan balance with the percentage cost based on the portion of the loan being covered, the number of years the policy will be in force, and the originating LTV ratio.

For example, the cost of a PMI policy covering the top 30 percent of a 95% loan for five years, would have annual renewal premiums ranging from 0.75% to 1.0% of the loan amount.

In the event of default and foreclosure, the lender is able to collect up to the limits of the policy coverage for the difference between the outstanding loan balance and the proceeds of the foreclosure sale.

If the policy is insufficient to cover any deficiencies, the lender may seek a judgment against the borrower. Individuals may be able to avoid PMI by using one of the several Piggyback loan structures previously discussed.

The Fixed Obligations or Back End Ratio considers the same components of monthly direct housing expenses, but adds the monthly cost of servicing other debt to which the prospective borrower is committed.

These obligations generally include any outstanding debt which has a payment schedule of six months or longer, …

…or other recurring periodic payments which the credit report has revealed. The most commonly considered obligation is installment debt for cars or other vehicles, appliance or furniture purchases, as well as revolving credit at department stores or credit card companies (i.e., VISA, Master Card, American Express, Discover, etc.).

To satisfy this underwriting guideline, total monthly payments for principle, interest, taxes, and insurance, plus other obligations must not exceed 36 percent for fixed rate, level payment loans and 33 percent for ARM's.

Lenders use these as guidelines for evaluating capacity in conjunction with evidence of other financial resources available to the borrower.

If, for example, a borrower fails one or the other test, the loan officer may consider the presence of other financial resources and liquidity, as evidenced by the applicant's statement of net worth. However, if much of the asset base contributing to the applicant's net worth is made up of real estate and other illiquid assets, some of which may have questionable market value, the lender may be more demanding with respect to adherence to the income rations, and thus require additional assurances or guarantees from the borrower pledging additional assets as collateral, or securing a signatory/guarantor on the loan.

Lenders may also place additional performance requirements on the borrower, such as maintaining a two months' reserve in an account equal to the total of two full payments of PITI (Principal, Interest, Taxes and Insurance).
In instances where buyers/borrowers are stretched to pay closing costs which cannot be rolled into the amount financed, sellers may also be allowed to contribute a share of the closing costs to facilitate the transaction.

The generally accepted guidelines are that sellers are permitted to contribute up to 3% of the sales price when the purchaser is making a 5% down payment (i.e., securing a 95% LTV loan), or up to 6% of the sales price for 90% LTV loans where the buyer/borrower is making a 10% down payment.

Conforming Government Insured Non-conventional Loans are offered predominantly through the Federal Housing Administration (FHA).

There are a variety of insured loan programs under the FHA umbrella that have evolved since the agency's establishment in 1934, as part of President Roosevelt's New Deal package of legislation designed to drive the U.S. economy out of the grips of the Great Depression. Although it is up to some debate whether the entire package of legislation was worth the cost, there is fairly wide agreement that the FHA met and even exceeded congressional expectations and created government-backed home mortgage loan programs that were very soon copied by private sector institutions.

The FHA currently offers a range of programs which individually can be tailored to meet the needs of specific segments of the housing market, and thus put affordable home ownership with the reach of many who otherwise would be temporarily sidelined, or even forever restricted from the prospect of owning their own home.

The balance of this discussion, however, will focus on the FHA 203 (b) Loan program, which is among the agency's oldest and, by far, most popular loan product. For more information regarding this and other FHA programs, access the FHA Single Family Housing Policy Handbook 4000.1. This handbook provides the most updated FHA guidelines for the different programs offered. You can access this handbook by visiting the HUD.gov website or by using the link below:

https://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/handbook_4000-1

The FHA 203(b) program applies to one to four unit owner occupied properties.

In most cases, the purchaser is buying a single unit to live in, but it is possible to purchase two unit, three unit, or four unit properties, as long as the borrower occupies one unit as a principal residence.

The borrower does not have to be a first time homebuyer, nor are they required to receive housing counseling to be eligible.

Counseling through a HUD approved counseling agency, however, is advised. FHA also strongly recommends that a home inspection be completed for the property, since the FHA approved appraiser focuses on the property's value as it relates to the loan, not its condition.

The 203(b) has the following guidelines, which in many respects are similar to the requirements for other FHA insured loans.
Maximum loan limits are established for each metropolitan region of the U.S., *and can be accessed at the HUD home website (www.gov.hud).*

Following the Housing and Economic Recovery Act of 2008 (HERA), FHA established a formula for determining mortgage loan limits.

The loan limit for standard non-high cost metropolitan areas is 115 percent of the median house price, but not lower than 65 percent of the current conforming loan limit.

Loan limits for high cost areas have also been established and cannot exceed 150% of conforming loan limits.
The minimum required down payment for FHA 203(b) loans as January 1, 2009 was set at 3.5% of the sales price or appraised value, whichever is lower.

In other words, the maximum LTV under this program is 96.5%. This is very attractive for many prospective purchasers, particularly first time buyers, who may have adequate income to meet qualifying ratio, but insufficient savings or cash reserves to make a large down payment.

Also, the FHA allows that funds to make the down payment, in addition to personal savings, may be drawn from family gifts, as well as from local, state, or non-profit down payment assistance programs that do not received any financial benefit from the transaction.

Additionally, in response to issues arising from the financial crisis, FHA rules were changed in 2010 to link down payment requirements to the applicant's credit score.

For those with credit scores below 580, the minimum down payment is now 10%, while those with scores below 500 are not eligible for an FHA insured mortgage.

While seller provided down payment assistance is allowed (normally no more the 3%), seller contributions towards closing costs can make a bigger difference. Seller contributions towards closing costs, which includes prepaids, can amount to 6% of the sales price of the property.

Income Qualification Ratios for FHA insured 203(b) loans also come in two “flavors”: The Front End and Back End Ratios.

The front end ratio is 31 percent of the gross monthly income *and is the amount allowed for total housing expenses, including principal, interest, taxes, insurance, mortgage insurance, and condominium or homeowner fees, if applicable.*

The back end ratio cannot exceed 43 percent of gross monthly income.

This includes payments to service total monthly debt, including the total housing expenses. Term debts that will be retired in under ten months are generally not included in the total debt payment figure, with the exception of credit card debt.

It is also important to point out that alimony and child support payments are subtracted from gross monthly income before calculating the front end ratio, *instead of counting them as a debt payment when calculating the back end ratio.*

Compensating factors can be taken into consideration if the front or back end ratio exceeds the 31% and 43% of the gross monthly income. If the applicant’s credit score is 580 or above, the front end ratio can go up to 37% and the back end ratio can go up to 47% as long as one of the following compensating factors is present:

-verified and documented cash reserves
-minimal increase in housing payment
-residual income

An applicant’s front end and back end ratio can go up to 40% if the applicant does not have any discretionary debt. Lastly, an applicant’s front end ratio can go up to 40% and back end ratio can go up to 50% if two of the following compensating factors is present:

-verified and documented cash reserves
-minimal increase in housing payment
-significant additional income not reflected in effective income
-residual income.

A Mortgage Insurance Premium (MIP) is required on FHA loans to protect the lender and secondary market investors in the event of default by the borrower.

There is an annual mortgage insurance premium (MIP) that is paid in monthly installments, in addition to an initial mortgage insurance premium paid at closing. Both are based on a percentage of the loan amount.

The initial, or upfront MIP, is generally financed as part of the loan, and is 1.75% of the loan amount, and that total is used to calculate the monthly loan payment.

It is, however, important to understand that the MIP is not actually a part of the loan made for the purchase of the property, and cannot be considered part of the tax deductible interest for the borrower. Legislation effective in January 2015 reduced the up-front MIP to 1.75%, but increased the annual MIP premium to 0.85% for loans with an LTV less than 95% and 0.90% for loans greater than 95%.

Up-front premiums for FHA’s Hope for Homeowners Program (those with delinquent loans) and home equity conversion mortgages are set at 2% of the loan amount.

In 2001, FHA’s mortgage insurance program followed the lead of changes instituted for PMI insurance. Under certain conditions, these changes provided for automatic amortization cancellation or borrower requested cancellation of premium payments.

Amortized cancellation now occurs as soon as the unpaid principal loan balance, excluding the financed up-front MIP, reaches 78 percent of the lower of the initial sales price or appraised value, *based on the initial loan amortization schedule.*

FHA determines when the mortgage reaches the amortized 78 percent loan-to-value threshold, based on the initial note rate and the loan-to-value information. FHA must disclose to the consumer the date when the mortgage insurance will automatically end, as well as the amortized loan balances as of that date.

Conforming government guaranteed non-conventional loans in the arena of home mortgage lending are almost exclusively the focus and intent of Veterans Administration (VA) programs.

Created as a gesture of national gratitude for their efforts, risks, and losses during World War II, Congress enacted the Serviceman's Readjustment Act of 1944, better known as the GI Bill. This legislation created the Veterans Administration (VA), now called the Department of Veterans Affairs, and included a home buying loan program that required virtually no down payment for qualified veteran applicants.

VA loans are guaranteed, not insured by the federal government.

They too, however, provide protection for originating lenders, focusing on the highest-risk portion of a highly leveraged loan. VA loans are highly standardized with respect to the application, appraisal and other processing documentation. They are instruments sold in the secondary mortgage market.

Veteran applicants must secure a Certificate of Eligibility, *which verifies that they were honorably discharged from one of the armed services, and that they served a minimum of 90 days active duty*.

Like FHA-insured loans which are originated according to secondary market guidelines, VA loans must also meet certain requirements to satisfy conforming loan standards.

These are discussed in the material that follows.
The VA Guarantee or Entitlement is the starting point for the veteran to establish his or her borrowing power.

Typically, a VA approved lender will originate loans up to four times the entitlement for which the veteran is eligible which very often results in a 100% LTV loan. In effect, the VA guarantees the top 25% of the loan, and thus removes the risk a lender would otherwise assume with such a highly leveraged mortgage.

The Certificate of Eligibility shows the amount of the entitlement for the veteran.

In some cases, the veteran may have a partial entitlement available if the amount to be guaranteed has increased since the last time eligibility was used. This is often the case when a VA loan is assumed by a non-veteran purchaser who receives the benefit of the existing loan terms as part of the transaction.

Eligibility for VA loans is limited to persons who are on

- active duty, or
- honorably discharged within 181 days of service (90 days if during a declared war);
- served a total of two years if service was after 1980 for enlisted personnel and 1981 for commissioned officers;
- served in the National Guard for a minimum of six years; or
- who are un-remarried widows or widowers of a deceased military member meeting one of the stated qualifications for eligibility.

> *Also, the veteran must acknowledge that he/she plans to occupy the property, which will serve as security for the VA loan.*

The Certificate of Eligibility is issued by the Department of Veterans Affairs and establishes the amount that is guaranteed on the VA loan.

The entitlement figure is clearly reported on the certificate obtained from the VA, and becomes an important component of the veteran's resources to purchase a home.

The entitlement represents 25% of the current FNMA/FHLMC conforming loan limits for one to four family dwellings.

Also, assuming the veteran applicant meets the required income qualification guidelines, lenders will originate loans that are four times the amount of entitlement. As previously mentioned, the results are loans requiring no down payments or out of pocket expenditures for closing costs. For loans exceeding the maximum amount allowable, veterans would be required to provide a sufficient down payment to complete the transaction.

In some cases, veterans could be eligible and qualified for VA's Super Max loan, which can go up to $1.0 million.

There is one Qualifying Ratio for VA loans. This ratio requires that all housing expenses, plus other long term debt payments, be equal to, or less than 41% of the gross monthly income.

However, unlike FHA and FNMA/FHLMC underwritten loans, VA lenders must also consider residual income.

Which is the amount remaining after payment of housing costs, and other debts are deducted from gross monthly income.

This amount must be sufficient to cover all other family living expenses based on guidelines adopted by the VA. This might mean, for example, that a veteran with a large family or additional dependents may be limited to a qualifying ratio under 41%. These guidelines for residual income vary by geographic region, considering local cost of living factors.

Compensating factors, such as those discussed in regard to FHA loans, may also be taken into consideration in establishing the veteran's final qualifying ratio.

A **Funding Fee** is charged at the origination of the loan.

It is, in effect, a fee charged for the privilege of obtaining a VA loan.

The fee is retained in a fund managed by the VA to cover administrative costs associated with the program, and to offset default losses that might not otherwise be covered by the agency's Congressional appropriation.

The amount of the fee is generally higher when the down payment is lower, and when the guarantee program is used on multiple or subsequent transactions.

The fee is also higher for those applying as reservists or as members of the National Guard. First time use funding fees typically range from 1.25% to 2.4%, while subsequent use fees range from 1.25% to 3.3%.

The funding fee is usually waived for veterans receiving service related disability payments, as well as for certain widows or widowers of deceased eligible veterans.

Also, the funding fee may be included in the total amount of the loan financed, but must be paid entirely with the maximum loan limit allowed on the transaction.

Seller contributions to closing costs are generally more liberal than FHA loan programs.

The seller may pay all of the VA purchaser's closing costs, including all discount points and other prepaid items.

The seller is also allowed to contribute up to 4% of the home's sale price to pay the funding fee, and/or reduce the total amount of the debt to a level that would make it easier for the borrower to meet income qualification guidelines.

The assumption of VA loans is possible and allowable, as long as the new purchaser assuming the loan obligations has been qualified by the lender.

When a veteran uses the existing VA loan to facilitate the sale of his/her home, there are two significant issues that need to be addressed.

The first is the issuance of a release of liability by the purchaser. This clearly states that the veteran is relieved of any and all liability for the loan.

The second is to request a restoration of entitlement based upon current eligibility levels. This would allow the veteran to pursue another home purchase using the VA loan program.

A Certificate of Reasonable Value is an appraisal of the property's fair market value by a VA approved independent fee appraiser.

If the value of the property is equal to, or greater than the purchase price, the veteran will in all likelihood be able to secure a no down payment loan.

The veteran will be able to proceed with the transaction if the sales price exceeds the CRV, but will be required to pay the difference as a cash down payment, the source of which must be approved by the VA.

LESSON SUMMARY

Qualifying the Title

- Assessing and securing assurances regarding the veracity and accuracy of the title rights associated with the real property being accepted as collateral by the lender/mortgagee.
- The recordation of written documents regarding real estate transactions provides the most complete resource possible for examining, verifying and authenticating the quality of title being transferred, or taken as collateral.
- The development and maintenance of recording systems, along with the introduction of information technology, allows for the efficient and relative rapid research of the historical record of property ownership.
- Private companies have been organized to sell insurance to indemnify property owners and lenders against losses arising from title deficiencies, such as those listed above, as well as from errors in title examination.

Closing the Loan

- Closing the loan transaction may or may not involve a transfer of title.
- There are two types of closing
  - Personal
  - Escrow

Escrow closing

- Based upon buyer and seller agreeing to secure the services of an Escrow Agent to represent both and perform all duties and responsibilities necessary to complete the transaction.
- Escrow agents must be disinterested third parties who are being compensated for their time and effort, and not based upon the value of the transaction.
- Escrow agents coordinate all closing related activities.
- The process begins when the purchase agreement is signed and ends typically 30 to 60 days later at the closing.

Finished closing

- Marks the end of a successful transfer of title and securing of credit to facilitate the transaction.
- Each of the involved parties, including the seller, buyer, lender, attorney, broker and escrow agent (title company), if different from the attorney, are responsible for completing various tasks.

Servicing the Loan

- There are three basic options governing the loan servicing process.
  - Originate, Hold and Service;
  - Originate, Sell and Service; or
  - Originate, Sell and Service Release.

Originate, Hold and Service

- Practiced by many lenders with limited secondary market experience, or who originate mostly nonconforming loans tailored to the individual needs of their local customers.
- Lenders book these as assets and retain them in their loan portfolio.

Originate, Sell and Service

- Similar to previous in that customer’s primary contact for matters regarding the loan is the originating bank or savings association.
- The originating lender retains servicing rights, and the direct relationship with the borrower is maintained.
- The arrangement to originate, sell the loan, but retain the servicing, is among the disclosures the lender must make to the borrower at, or before, the closing.

Originate, Sell and Service Release

- Is the least preferred by borrowers, since once the loan is sold, the originating institution is largely out of the picture.
- The third party is then responsible for collecting payments, forwarding principal and interest payments to the investors or their agents, managing escrow accounts for taxes and insurance, and making disbursements at the appropriate time.

Qualifying the Borrower

- An important initial step in the loan origination process that follows a series of steps focused largely on determining how much the borrower can afford to borrow, and how much the lender can expect to lend with a reliably measured prospect of being paid back.

Property search

- Made more efficient if the prospective purchaser has been pre-qualified or pre-approved by a lender.
- A pre-approval letter from a lender is a strong statement of credit worthiness of the prospective borrower/purchaser.
- The issuance of a pre-approval letter typically means the lender has completed all the steps encompassed within a pre-qualifying process

Evaluating affordability

- Lenders rely on underwriting guidelines established for conventional loans conforming to the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), or Fannie and Freddie.
- Agencies such as the FHA and VA utilize their own criteria for underwriting capacity risk.

Ratios to measure risk

- Mortgage Debt Service, or Front End Ratio, and the Fixed Obligations, or Back End Ratio.

Front end

- Considers the financial obligations directly associated with the loan and property acquisition in relation to the gross income of the borrower(s).
- To qualify under the criteria, the Front End Ratio must not exceed 28 percent of gross monthly income for fixed rate, level payment loans, or 25 percent for adjustable rate loans under the predominant loan underwriting standards currently in use. These ratio criteria may change in relation to cost and availability of funds.

Private Mortgage Insurance (PMI)

- A PMI policy covering the top 30 percent of a 95% loan for five years, would have annual renewal premiums ranging from 0.75% to 1.0% of the loan amount.
- In the event of default and foreclosure, the lender is able to collect up to the limits of the policy coverage for the difference between the outstanding loan balance and the proceeds of the foreclosure sale.

The Fixed Obligations or Back End Ratio

- Considers the same components of monthly direct housing expenses, but adds the monthly cost of servicing other debt to which the prospective borrower is committed.
- These obligations generally include any outstanding debt which has a payment schedule of six months or longer
- Total monthly payment obligations must not exceed 36% for fixed rate, level payment loans and 33% for ARM's.
- Lenders use these as guidelines for evaluating capacity in conjunction with evidence of other financial resources available to the borrower.
- Lenders may also place additional performance requirements on the borrower, such as maintaining a two months' reserve in an account equal to the total of two full payments of PITI (Principal, Interest, Taxes and Insurance).
- Where buyers/borrowers are stretched to pay closing costs which cannot be rolled into the amount financed, sellers may also be allowed to contribute a share of the closing costs to facilitate the transaction - up to 3% of the sales price when the purchaser is making a 5% down payment.

FHA Loans - The FHA offers a range of programs which can be tailored to meet the needs of specific segments of the housing market, putting affordable home ownership reach of many who otherwise would be temporarily sidelined, or forever restricted from home ownership.

FHA 203(b)

- Applies to one to four unit owner occupied properties.
- The borrower does not have to be a first time homebuyer, nor are they required to receive housing counseling to be eligible.
- The 203(b) has the following guidelines, which are similar to the requirements for other FHA insured loans.

Maximum loan limits

- Loan limit for standard non-high cost metropolitan areas is 115% of the median house price, but not lower than 65% of the current conforming loan limit.
- Loan limits for high cost areas have also been established and cannot exceed 150% of conforming loan limits.

FHA 203(b) minimum down payments

- As of January 1, 2009 was set at 3.5% of the sales price or appraised value, whichever is lower.

- FHA allows that funds to make the down payment, in addition to personal savings, may be drawn from family gifts, as well as local, state, or non-profit down payment assistance programs.
- In 2010, FHA rules were changed to link down payment to applicant's credit score.
- For those with credit scores below 580, the minimum down payment is now 10%. Scores below 500 are ineligible for an FHA mortgage.
- Seller provided down payment assistance is allowed, limited to 3% of the purchase price.
- Seller contributions towards closing costs are limited to 6% of the purchase price.

Income qualification ratios
- The FHA insured 203(b) loans come in two flavors: The Front End and Back End Ratios.
- Front end: 31% of gross monthly income (GMI)
- Back end: Cannot exceed 43% of GMI

Compensating factors
- May be considered by the loan underwriter if an applicant's front end ratio exceeds 31%.
    - Larger down payment
    - Low non-housing related long term debt
    - Minimal use of credit cards
    - Good to excellent employment history
    - Supplemental income
    - History of making higher payments

Mortgage Insurance Premium (MIP)
- Required on FHA loans to protect the lender and secondary market investors in the event of default by the borrower.
- The initial MIP, is generally financed as part of the loan. As of April 2010 it was 2.25% of the loan amount.
- Up-front premiums for FHA's Hope for Homeowners Program and home equity conversion mortgages are set at 2% of the loan amount.
- In 2001, FHA's MIP changed to provide for automatic amortization cancellation or borrower requested cancellation of premium payments.

VA Loans
- Almost exclusively the focus and intent of Veterans Administration (VA) programs
- VA loans are guaranteed, not insured by the federal government.
- Veteran applicants must secure a Certificate of Eligibility.
- VA loans must also meet certain requirements to satisfy conforming loan standards.

VA Guarantee or Entitlement
- The starting point for the veteran to establish his or her borrowing power. VA approved lender will originate loans up to four times the entitlement for which the veteran is eligible often resulting in a 100% LTV loan.
- The Certificate of Eligibility shows the amount of the entitlement for the veteran.

VA loan eligibility
- Limited to persons who are:
    - Active duty
    - Honorably discharged within 181 days of service (90 days if during a declared war)
    - Served a total of two years
    - Six year National Guard service
    - Un-remarried widows or widowers of a deceased military member

Certificate of Eligibility
- Issued by the Department of Veterans Affairs and establishes the amount guaranteed on the VA loan.
- The entitlement represents 25% of the current FNMA/FHLMC conforming loan limits for one to four family dwellings.
- In some cases, veterans could be eligible and qualified for VA's Super Max loan, which can go up to $1.0 million.

Qualifying Ratio for VA loans
- This ratio requires that all housing expenses, plus other long term debt payments, be equal to, or less than 41% of the gross monthly income (GMI).

- Residual income is the amount remaining after payment of housing costs, and other debts are deducted from GMI.
- Other compensating factors may be taken into consideration to set the qualifying ratio.

Funding fee

- Charged for the privilege of obtaining a VA loan.
- The fee is higher when the down payment is lower, and when the guarantee program is used on multiple or subsequent transactions.
- Funding fees range from 1.25% to 3.3%
- Usually waived for disabled veterans and widows or widowers of deceased veterans.

Seller contributions

- Seller contributions to closing costs are generally more liberal than under FHA loan programs.
- The seller may pay all of the VA purchaser's closing costs, including all discount points and other prepaid items.
- The seller may contribute up to 4% of the home's sale price to pay the funding fee, and/or reduce the total amount of the debt to make it easier for the borrower to meet income qualification guidelines.

Assumption of VA loans

- Possible and allowable, as long as the new purchaser assuming the loan obligations has been qualified by the lender.
- Two issues need to be addressed:
    - Release of liability
    - Request a restoration of entitlement based upon current eligibility levels

Certificate of Reasonable Value

- An appraisal of the property's fair market value by a VA approved independent fee appraiser. .
- If sales price exceeds CRV and the veteran pays the difference as a cash down payment, the VA must approve funding source.

Qualifying the Buyer
- Income
- Debts
- Down payment
- Maximum Qualifications

Borrowers Comfort Zone
- PITI
- Sales price
- Loan amount
- Property taxes
- Insurance

Qualifying to Program
- VA & Rural Development
- FHA & Conventional
- Income to Debt ratio
- Credit Rating and Score
- Property requirements

Shopping for Interest Rate
Qualifying the property
Title Search
Loan Application

Qualifying the Buyer

Qualifying the buyer is the first order of the business for the mortgage origination professional.

When approached by a borrower, some factors will be known and others must be determined based on:
- Income
- Debt
- Down Payment
- Maximum Qualifications

Qualifying the Borrower

INCOME

Gross Monthly Income (GMI)
- Salary – (wages from paychecks); year-to-date income divided by the effective months on the pay stub.
- Self-Employed and Commission or Bonus Income – average the net income after expenses and gross adjusted income before taxes from Schedule "C" for the most current 2 years.

DEBTS

List of Monthly Obligations
- For all debts (beginning with those on the credit report) use the minimum payments.
- Add in debts not listed on the credit report and use minimum payment on the monthly statements or use 4% of the balance as the minimum required payment.

Down Payment, Closing Costs, and Pre-paid Insurances and Taxes

- US Dept. of Agriculture and VA allow $0 down
- FHA allows 3.5% down
- Conventional uses 3% to 20 % down with private mortgage insurance (PMI)
- With 20% down, PMI is not required

Maximum Qualifying for Conventional Loans

GMI x 36% – debts = Max PITI
We already know: Loan amount x factor = P&I
So: P&I / Factor is the Loan Amount
Therefore: PITI – Insurance & Taxes = P&I
PITI x 70%* = Estimated P&I

*Insurance and taxes typically make up around 30% of a monthly mortgage payment.

Maximum Qualifying for FHA

GMI x 43% (or up to 50% with compensating factors) – debts = Max PITI
We already know: Loan amount x factor = P&I
So: P&I / Factor is the Loan Amount
Therefore: PITI – Insurance & Taxes = P&I
PITI x 70%* = Estimated P&I

*Insurance and taxes typically make up around 30% of a monthly mortgage payment.

Maximum Qualifying for VA

GMI x 41% – debts = Max PITI
See chart for residual family income; # of family members determines the income less debts to equal an amount required for family support.
See www.VA.gov for updated guidelines.

Maximum Qualifying for Department of Agriculture (USDA – Rural Development)

GMI x 41% – debts = Max PITI
See chart for residual family income; # of family members determines the income less debts to equal an amount required for family support.
See www.VA.gov for updated guidelines.

Other Factors Used to Support Loan Approval

GMI x 41% – debts = Max PITI
See chart for residual family income; # of family members determines the income less debts to equal an amount required for family support.
See www.VA.gov for updated guidelines.
The most important question to ask your borrower:

"What is the highest monthly payment you are comfortable with?"

Once you establish that payment amount you can then work the math to determine maximum loan amount to consider and how much home the buyer can afford.

Example: Mr. and Mrs. Buyer want a maximum monthly house payment (PITI) not to exceed $1,800.00.
Step 1:
$1800 (PITI) x 60%(insurances and taxes) = $1080.00 (estimated P&I) Multiplying by the 60% isolates the P&I from the expected total payment.

Step 2:
$1080/ .00599 = $180,300.00
(.00599 is the factor for the base loan 6% Rate for 30 years)

Step3: (For FHA w/3.5% down)
$180,300 / 96.50% = $186,839.00 (Sales Price).

Check the Math

$186,839 (Sales Price) $186,839 (Sales Price)
X 96.50% -180,300 (Base Loan
$180,300 (Base Loan)6,539 Down payment

Base loan amount: $180,300 x 101.75% = $183,455.00 with Annual Mortgage Default Insurance financed into the loan amount.

Loan amount: $183,455 (with MIP) x .00599 = $1,098 P & I
$183,455 x 1.9% ÷ 12 = $ 290 Est. Homeowners
$183,455 x 0.9% ÷ 12 = $ 137 Est. Flood Insurance
Sale price: $186,839.00

Taxes and Mortgage Insurance

$186,839 (Sales Price)
– (78,000 *Homestead Exemption* x 1.3%) ÷ 12 months = $ 121
Property Tax

$180,300 (Base Loan) x 1.35% ÷ 12 months = $203
Monthly Insurance

$1849 Monthly Payment

In the big world of Real Estate and Mortgages, this is close enough to set expectations for a consumer to know his shopping limits.

Cash is the first consideration in determining what type of mortgage is most appropriate. The amount of cash available for the down payment, closing costs, and pre-paid insurances differs from one program to another.
VA and Rural Development are the least cash expensive programs.

The function of VA program is to guarantee investors against losses through foreclosure.

Always ask if the client is a Veteran since with VA loans there is no down payment requirement and the sellers are allowed to pay all of the closing costs and pre-paids.

Many questions regarding VA can be answered at
www.benefits.va.gov/warms/pam26_7.asp

VA and Rural Development are the least cash expensive programs.

Rural Development function is to promote population of Rural America.

Rural Development from the Department of Agriculture also provides for no down payment as long as the property is located in an acceptable area.

More information can be found on their web site:
www.rurdev.usda.gov/Home.html

FHA:
Insures investors against losses through foreclosure. The losses are paid through the mortgage default insurance charged to the borrower as part of the loan.

- FHA requires a minimum of 3.5% of the sales price on the part of the purchaser.
- The total cost for minimal down payment, closing costs, and pre-paids is approximately 10% of the sales price. Sellers, brokers, and lenders are allowed to pay up to 6% of the sales price on behalf of the borrower. Lender's portion can be paid through above-par pricing.
- Gift funds from a family member are allowed for all of the cash required.

Conventional Mortgages.

- If the applicant is a first time homebuyer, the minimal required down payment is 3%.
- If the applicant is not a first time homebuyer, the requisite minimal down payment is 5%.
- With 5% down, the closing cost and pre-paid requirements will average another 10%.
- At 5% down, the sellers, brokers, and lenders will only be allowed to pay up to 3% of the sales price to assist the borrower.
- At greater than 10% down, the sellers, brokers and lenders are allowed to pay up to 6% of the sales price to assist the borrower.
- Gifts are allowed from family members after the purchasers demonstrate their own funds of 5%, unless the gift is greater than or equal to 20% for down payment.
- Reduced down payment and qualifying may be available to clients who qualify under FNMA Community Home Buyers Program.

Income-to-Debt-Ratio is the second most important factor in deciding the mortgage type.

If an applicant cannot qualify under the Conventional guidelines of 28/36 then try FHA or Rural Development of 31/43.
Credit Rating and Score

- The credit scores required for conventional mortgages are more demanding than FHA.
- Investors will also require rate and pricing adjustments on lower credit scores.
- It is the MLO's job to research individual lender requirements for scores and pricing adjustments.

Property Requirements – The physical condition of the subject property must meet the investor's guidelines. They must be able to sell the property in the event of a foreclosure.

FHA offers a program designed for the purchase and renovation of properties. The restorations help improve the property and allow it to meet FHA standards or to the borrowers' acceptable condition.

- Streamline 203-K lends to purchase and renovate non-structural conditions.
- Standard 203-K lends to purchase and renovate both structural and non-structural conditions.
- 203-K does NOT lend to expand square footage.

"How to shop for the best interest rate for one's mortgage" covers a lot of ground. The "Best Deal" is always at the root of a consumer's quest. In order to become the trusted advisor that successful MLO's seek to become, information is the key. Information is also a source and sum of experience necessary to attract and retain clients and resources.

What are mortgage rates based upon?

The only correct answer to this is Mortgage Backed Securities or Mortgage Bonds. The mortgage industry in the United States is the most effective instrument in the history of the world for the redistribution of wealth.

Those that can invest allow the "have not's" the single greatest opportunity to have more than the previous generation.

The investments made in Mortgage Backed Securities yield a modest yet very stable return on large sums.

The market for the purchase of mortgages makes money available to the public for the single most important physical possession in their lives.

The availability of this money is governed by the statistics of delinquency and default. The instruments used for the purchase of mortgages reflect the lending side as evaluated in the market at the time of the transaction. The sales of Mortgage Backed Securities directly reflect the Risk Management associated with the parameters utilized to produce lending guidelines. This is why Mortgage Backed Securities and not the 10 year Treasury Bonds should be used by MLOs to produce short term predictions for interest rate movements.
Wall Street investors are charged daily with the investment of money for profit in the name of others. They continually weigh the risks vs. rewards in selecting investments. As the stock market, the value of currency, and the forecast of inflation influence the decisions, the safety and predictability of Mortgage Backed Securities frequently become a haven for weathering a storm.

As soon as the potential for profit outweighs the potential for disaster, the investors return to stocks.

When the Fed changes their rates, how does this impact mortgages? The Federal Reserve functions as a clearing house for banks to balance their books daily. This balancing is accomplished by borrowing from the Fed on a short term basis. The cost for this overnight borrowing partly produces a bank's cost to operate and hence, their cost of funds to lend.

An increase in the Fed Funds Rate is seen as inflationary. This pressure on the costs to the banks will cause more expensive rates for credit cards, auto loans, lines of credit, and other short term lending. It does not directly translate to mortgage rates. Eventually the attraction to greater return on investment dollars will increase competition for available funds and mortgage rates will need to rise.

Clients seeking the lowest rate and the lowest cost need help to interpret multiple offers prior to committing themselves to a MLO. They need to feel confident that they are placing the largest purchase of their lives in capable hands. After committing to a MLO, they need current, reliable information. The next test after that commitment is advice on whether to "Lock" or "Float" until later and hope for lower rates prior to closing and lock then.

Some lenders even offer programs that protect the selected rate and price (points) with an option to float down but not up. This added element of risk to the secondary marketing department of the company must be paid for. There will be gains and losses to balance. The consumer will pay a price in rate and/or price (points) for this opportunity. Most commonly, once a rate and price (points) are agreed upon and the number of days for the lock is established, there are no changes available. Be sure you can get to a closing in the agreed upon time frame as an expired lock never affords MLO or the client an opportunity for lower rate, lower costs, or increased commission.

Frequently the MLO will be confronted with the client's offer from another lender. The only way to analyze the offer from a competitor is through the comparison of Estimate Worksheets. Generally, the only flexible cost in the pricing of a loan will be the MLO's commission. Hard costs, insurances, taxes, title company fees and lender costs are not going to be flexible.

There will also be opportunity to review the competitor's costs and fees along with loan program, lock period, and estimates for insurance and taxes to see if the competitor's is realistic. Take every effort to explain that the insurance, taxes, interim interest charges, and title company charges are not in your control. These figures should not be part of lender fees, points, and rates offered by any lender. They will be whatever they are. Underestimating them for the sake of a more aggressive estimates and then finding more cash is needed to close at the end serves no one. MLO's do not set actual figures and have no control over taxes, insurances, appraisal fees, title companies or interim interest charges.

Qualifying the property

Qualifying the property is essentially a matter of having the collateral appraised and inspected. The appraisal is focused on establishing a Fair Market Value for loan purposes, while the inspections are to verify the collateral's condition and corroborate disclosures made by the current owners/sellers.

Since appraisals and inspections are heavily covered elsewhere in this training, this is only a reminder of the importance of qualifying the property early in the loan application process.

Titles

Between the MLO and management, there should be an agreement as to whose job responsibility it is to order the title reports and when. Define clearly the responsibility for ordering the title and reviewing the chain of title. Seek out a well-known and respected title company then request a meeting to establish a relationship.

Develop a relationship that allows you to be in step with what they need to make your loans go smoothly. Historically, realtors have been allowed to select a title company from a list of approved companies. More and more lenders are now requesting a 24 month chain of title to help avoid flipping, churning, and equity stripping. The primary function of the title company is to execute the lender's closing instructions for closing the loan and issuing acceptable title insurance.

Investor title insurance coverage is the minimal acceptable insurance considered by the lender as protection against a flaw or challenge to titles of a property. It insures against defect or challenge to the amount of the existing mortgage. In the event of a successful challenge to full rights and ownership, the insurance covers payment of the claim to the limit of the policy. The payment of any such claim is made to the lender for investor coverage then the homeowner if there is an owner policy.

Title insurance insures the mortgage company for the merchantability of and validity of the title which is limited to the mortgage company's interest in the title. The insured is the mortgage company and the insurance limit is the current loan amount owed to the lender.

Owner's title insurance coverage is level coverage. This coverage insures to the limit of the policy for uninterrupted ownership. Owner's coverage is generally set at the sales price and the coverage remains at the policy limit for the duration of the ownership.

Loan Application

A mortgage application provides prospective lenders with information needed to make the decision on whether or not to lend money to a borrower for a specific piece of property.

The Uniform Residential Loan Application (URLA) covers five specific areas of information.

Section 1: Type of Mortgage and Terms of Loan
Section 2: Property Information and Purpose of Loan
Section 3: Borrower Information
Section 4: Employment Information
Section 5: Monthly Income and Combined Housing Expense Information

LESSON SUMMARY

Qualifying the Borrower
- The first order of the business for the mortgage origination professional. Loan Approval will hinge on:
- Income, debt, down payment, & maximum qualifications

Income
- Gross Monthly Income (GMI) – Salary (wages from paychecks); Self-Employed and Commission or Bonus Income – average the net income after expenses and gross adjusted income before taxes from Schedule "C" for the most current 2 years.

Debts
- Monthly obligations: All debts using minimum payments
- Use 4% of balance of debts not shown on credit report.

Down Payment, Closing Costs, and Pre-paid Insurances and Taxes
- US Dept. of Agriculture and VA allow $0 down
- FHA allows 3.5% down
- Conventional uses 3% to 20 % down with private mortgage insurance (PMI)
- With 20% down, PMI is not required

Maximum Qualifying for Conventional Loans
- GMI x 36% – debts = Max PITI
- Loan amount x factor = P&I
- P&I / Factor is the Loan Amount
- PITI – Insurance & Taxes = P&I
- PITI x 70%* = Estimated P&I

  * (Insurance and taxes typically make up around 30% of a monthly mortgage payment.)

Maximum Qualifying for FHA
- GMI x 43% (can be up to 50% with compensating factors)– debts = Max PITI (Insurance and taxes typically make up around 30% of a monthly mortgage payment.)

Maximum Qualifying for VA
- GMI x 41% – debts = Max PITI

Maximum Qualifying for USDA – Rural Dev
- GMI x 41% – debts = Max PITI

Other factors used to support loan approval

- Borrower has proven ability to pay housing expenses
- Large down payment (10% or more)
- Borrower has demonstrated an ability to accumulate savings and a conservative attitude toward credit.
- Credit history shows borrower has devoted a greater portion of income to housing expenses.
- Borrower receives other documented income
- Minimal increase in borrower's housing expense
- Borrower has substantial non-taxable income
- Potential for higher future earnings
- Home is being purchased for relocation of primary wage-earner and secondary earner has reasonable prospects for securing employment.

Borrower's Comfort Zone

- Establish the maximum payment amount for the borrower and then work the math to determine maximum loan amount to consider how much home the buyer can afford.

Qualifying to Program

- Cash is the first consideration in determining what type of mortgage is most appropriate. The amount of cash available for the down payment, closing costs, and pre-paid insurances differs from one program to another.
- VA and Rural Development are the least cash expensive programs and under certain conditions may not require a down-payment.

Qualifying to Program - FHA

- Insures investors against losses through foreclosure.
- FHA requires a minimum of 3.5% of the sales price on the part of the purchaser.
- The total cost for minimal down payment, closing costs, and pre-paids is approximately 10% of the sales price.
- Sellers, brokers, and lenders are allowed to pay up to 6% of the sales price on behalf of the borrower. Gift funds from a family member are allowed.

Conventional Mortgages

- Require a minimal down payment of 5%.
- With 5% down, the closing cost and pre-paid requirements will average another 10%.
- At 5% down, the sellers, brokers, and lenders are only allowed to pay up to 3% of the sales price for the borrower.
- At greater than 10% down, 6% of the sales price can be paid by sellers, brokers and lenders.
- Gifts are allowed from family members after the purchaser's demonstrate their own funds of 5%, unless the gift is greater than or equal to 20% for down payment. .
- Reduced down payment and qualifying may be available to clients who qualify under FNMA Community Home Buyers Program.

Qualifying to Program

- Income-to-Debt-Ratio is the second most important factor in deciding the mortgage type.
- If an applicant cannot qualify under the Conventional guidelines of 28/36 then try FHA or Rural Development of 31/43.

Credit rating and score

- The credit scores required for conventional mortgages are more demanding than FHA.
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Property Requirements

- The physical condition of the subject property must meet the investor's guidelines.
- FHA offers a program designed for the purchase and renovation of properties.

Interest rates

- Mortgage rates are based on Mortgage Backed Securities or Mortgage Bonds. Investments made in Mortgage Backed Securities yield a modest yet very stable return.

Qualifying the Property

- Qualifying the property is essentially a matter of having the collateral appraised and inspected. The appraisal is focused on establishing a Fair Market Value for loan purposes, while the inspections are to verify the collateral's condition and corroborate disclosures made by the current owners/sellers.

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