Section 12 – Part 4

SLIDE 1 – Common Mortgage Features (Cover Page)

SLIDE 2

Down Payment

In most cases buyers are required to make down payments to purchase a home.

Down payments can range from as little as 3% to as much as 20% or higher.

SLIDE 3

Financial Components of a Loan

The financial components of a mortgage loan include:

Principal

Interest and interest rate

Points

Term

Payments

SLIDE 4

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

SLIDE 5

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

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

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

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Points – From the point of view of a lender or investor, the amount loaned in a mortgage loan is the lender's capital investment, and the interest paid by the borrower is the return earned by the invested capital. It is often the case that a lender needs to earn a greater return than the interest rate alone provides.

For example, a lender may require additional yield on a low-interest VA loan which has an interest rate maximum. In such a case, the lender charges up-front discount points to make up the difference between the interest rate on the loan and the required return. This effectively raises the yield of the loan to the lender.

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

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The value of one discount point to a lender is usually estimated to be equivalent to raising the interest rate on the loan by 1/8%. Thus, a lender has to charge eight points to raise the yield by 1%.

If a lender needs to earn 7% on a loan offered at 6.5%, the number of points necessary would be figured as follows:

7.0% - 6.5% = .5%

.5% x 8 (points per 1%) = 4 points

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

100,000 x .04 = $4,000

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The borrower would effectively receive from the lender $96,000, and owe principal and interest based on $100,000. For tax reasons, it is usually advisable for the borrower to receive the full loan amount from the lender and pay the points in a check which is separate from that used for other closing costs.

As pre-paid interest, points paid in this way may be deductible on the borrower's income tax return for the year of the purchase. The borrower should seek the advice of a tax consultant concerning this matter.

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

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Payments – The loan term, loan amount, and interest rate combine to determine the periodic payment amount. When these three quantities are known, it is possible to identify the periodic payment from a mortgage table or with a financial calculator.

Mortgage payments are usually made on a monthly basis. On an amortizing loan, a portion of the payment goes to repay the loan balance in advance, and a portion goes to payment of interest in arrears.

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For example, Mary and Jerry King borrow $80,000 to finance the purchase of a home. The loan has a term of thirty years at an interest rate of 6.5% and is amortizing. The monthly payment for this loan will be $503.62. For the first payment at the end of the month, the Kings owe interest on $80,000 for the monthly period. At 6.5%, this amounts to $433.33. Since their payment is $503.62 and the interest charge is $433.33, the difference is applied to an advance payment of principal, which is $70.29. The following month, the Kings will pay interest on the new, smaller loan balance of $79,929.71 ($80,000.00 - 70.29).

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

SLIDE 12

Loan-to-Value Ratio

LTV Ratios

A **loan-to-value** ratio is simply the ratio of money borrowed on a property to the property's fair market value.

$$\boxed{\frac{\text{Mortgage Balance}}{\text{Home Value}} = \text{LTV Ratio}}$$

$$\boxed{\frac{\$\ 175{,}000}{\$\ 200{,}000} = 87.5\%}$$

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Lenders use the LTV ratio as a way to judge the risk of making a particular mortgage loan.

Most lenders put a cap on what the maximum LTV percentage they will loan.

Here are some example LTV calculations:

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Home price:	$120,000
Appraised value:	$130,000
Down payment:	$ 20,000
Loan amount:	$100,000
Loan-to-value (LTV):	76.9 %

SLIDE 15

Home price:	$120,000
Appraised value:	$110,000
Down payment:	$ 20,000
Loan amount:	$100,000
Loan-to-value (LTV):	90.9 %

SLIDE 16

Home price:	$120,000
Appraised value:	$110,000
Down payment:	$ 10,000
Loan amount:	$110,000
Loan-to-value (LTV):	100.0 %

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Loan Servicing

The primary lender assumes the initial risk of the long-term investment in the mortgage loan. Primary lenders sometimes also service the loan until it is paid off.

Servicing loans entails collecting the borrower's periodic payments, maintaining and disbursing funds in escrow accounts for taxes and insurance, supervising the borrower's performance, and releasing the mortgage on repayment.

In many cases, primary lenders employ mortgage servicing companies, which service loans for a fee.

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Escrow Accounts

Section 10 under RESPA sets limits on amounts a lender can require a borrower to maintain in an escrow account for insurance, taxes, and any other property related charges. If this provision is violated the seller shall be liable to the buyer in an amount equal to three times the charges for title insurance.

- An escrow account is:
  - A system that guarantees to the lender the taxes and property insurance will be paid.
  - A non-interest bearing account designed for use in paying borrower's annual taxes, insurance and any other charges related to the property.

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- The same method is performed for city and parish/county taxes:
  - The lender will charge the borrower 1/12 of the total annual taxes and places this amount in the escrow account each month
  - At the end of the one-year period, funds are available to pay the taxes

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Monthly Installment Payments (PITI)

PITI is an acronym for a mortgage payment that is the sum of monthly **P**rincipal, **I**nterest, **T**axes, and **I**nsurance.

PITI is the sum of the monthly loan service (principal and interest) plus the monthly property tax payment, homeowner's insurance premium, and, where applicable, mortgage insurance premium and HOA fees.

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Loan Origination Fee

Origination fee

Covers the work involved in originating the loan

- Origination - Decision making process to decide if the loan is a good credit risk
  - Verifying income, debts, employment, etc.

Charged in almost every mortgage transaction

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Take-Out Commitment

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