Course 1 – Section 13: Types of Mortgages and Sources of Financing

Section 13 – Part 1

SLIDE 1 – COVER PAGE

SLIDE 2 – TOPICS

In this section we will cover the following topics:

I. Conventional mortgages
II. Common Types of Mortgages
III. Custom mortgages
IV. Government Insured FHA Program
V. VA loan guarantee program
VI. Qualifying for a loan
VII. Primary sources of home financing
VIII. Secondary Mortgage Market
IX. Mortgage Fraud
X. Laws regarding fair credit and lending procedures

SLIDE 3 – LEARNING OBJECTIVES

Upon completion of this lesson, you should be able to:

- Describe the mechanics of an adjustable rate mortgage and the components of an ARM
- Describe the features of an amortized mortgage and amortize a level-payment plan mortgage when given the principal amount, the interest rate and the monthly payment amount
- Distinguish among the various types of mortgages
- Describe the characteristics of FHA mortgages and common FHA loan programs
- Identify the guarantee feature of VA mortgage loans and the characteristics of VA loan programs
- Explain the process of qualifying for a loan and how to calculate qualifying ratios

SLIDE 4 – LEARNING OBJECTIVES – (continued)

- Distinguish among the primary sources of home financing
- Describe the role of the secondary mortgage market and know the features of the major agencies active in the secondary market
- Describe the major provisions of the federal laws regarding fair credit and lending procedures
- Recognize and avoid mortgage fraud

SLIDE 5 – KEY TERMS

Here are some key terms we'll encounter in this lesson:

- **adjustable rate mortgage (ARM)** – loan with an interest rate that is periodically adjusted to reflect changes in a specified financial index
- **amortized mortgage** – a mortgage loan with scheduled periodic payments that consist of both principal and interest based on the remaining balance
- **biweekly mortgage** – a mortgage that requires payments every two weeks and helps repay the loan over a shorter term.

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- **conforming loan**– a mortgage that is equal to or less than the dollar amount established by the conforming loan limit set by Fannie Mae and Freddie Mac
- **disintermediation** – a disengagement process when depositors withdraw money from savings for investment in stocks money market funds and other securities
- **home equity loan** – a loan that allows owners to borrow against the equity in their homes
- **index** – financial tables used by lenders to calculate interest rates on adjustable mortgages and on Treasury bills

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- **intermediation** – the process whereby financial middlemen consolidate many small savings accounts belonging to individual depositors and invest those funds in large diversified projects
- **level payment plan** – type of mortgage that requires the same dollar payment each month or payment period
- **lifetime cap** – limit on the amount that a loan rate can move during the term of the mortgage
- **margin** – the lender's "retail markup" on the mortgage
- **MIP** – The Mortgage Insurance Premium defined by FHA

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- **mortgage broker** – a company that matches lenders with prospective borrowers who meet the lender's criteria
- **mortgage fraud** – the intent is to materially misrepresent or omit information on a mortgage loan application to obtain a loan or larger loan than would have not been obtained had the lender or borrower known the truth
- **mortgage loan originator** – an institution or individual that works with a borrower to complete a mortgage transaction

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- **negative amortization** – when a borrower's monthly payment is not large enough to cover both the principal and interest of a loan and the loan balance grows larger
- **non-conforming loan** – a mortgage that does not meet the guidelines of Government Sponsored Enterprises (GSE) such as Fannie Mae and Freddie Mac
- **package mortgage** – a loan that includes both real and personal property as security for the debt
- **partially amortized/balloon mortgage** – buyer makes payments smaller than are required to completely pay off the loan by its date of termination. Balloon payment due on loan maturity date.

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- **payment cap** – limits the amount monthly payments on an adjustable rate mortgage may change
- **periodic cap** – the highest % above the current rate at a set interval of time
- **purchase money mortgage** – a mortgage issued to the borrower by the seller of the home as part of the purchase transaction
- **reverse annuity mortgage** – allows elderly homeowners to borrow against their equity
- **teaser rate** – An low, short-term rate offered on a mortgage to entice the borrower

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- **UFMIP** – Up-Front Mortgage Insurance; An insurance premium that is collected, typically on Federal Housing Administration (FHA) loans, at the time the loan is made

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Let's look at conventional mortgages.

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A conventional mortgage loan is a permanent long-term loan that is not FHA-insured or VA-guaranteed. Market rates usually determine the interest rate on the loan. Because of the lack of insurance or guarantee by a government agency, the risk to a lender is greater for a conventional loan than for a non-conventional loan.

This risk is usually reflected in higher interest rates and stricter requirements for the down payment and the borrower's income qualification. At the same time, conventional loans allow greater flexibility in fees, rates, and terms than do insured and guaranteed loans.

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

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

Mortgage insurance – The lender may require the borrower to obtain *private mortgage insurance, or PMI*. Mortgage insurance protects the lender against loss of a portion of the loan (typically 20-25%) in case of borrower default.

Private mortgage insurance generally applies to loans that are not backed by the Federal Housing Administration (FHA) or Veterans Administration (VA) and that have a down payment of less than 20% of the property value.

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

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Income qualification

Lenders want to be assured that the borrower has adequate means to make all necessary periodic payments on the loan in addition to other housing expenses and debts such as credit card payments and car payments. Most lenders use two ratios to estimate an applicant's ability to fulfill a loan obligation: an *income ratio,* or *housing ratio*, and a *debt ratio*, or *housing plus debt ratio*. They also consider the stability of an applicant's income.

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Income qualification

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

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

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Income qualification

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

Monthly gross income x Income ratio = Monthly housing expense

Most conventional lenders require this ratio be *no greater than 25-28%*. In other words, a borrower's total housing expenses cannot exceed 28% of gross income.

For an FHA-backed loan, the ratio is 29%. VA-guaranteed loans do not use this qualifying ratio.

For example, if a couple has combined monthly gross income of $4,000, and a lender's maximum income ratio is 28%, the couple's monthly housing expense cannot exceed $1,120:

$4,000 x 28% = $1,120

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Income qualification

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

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

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Income qualification

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

Monthly gross income x Debt ratio =
Monthly housing expense + Monthly Debt obligations

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

Using the 36% debt ratio, the couple whose monthly income is $4,000 will be allowed to have monthly housing and debt obligations of $1,440:

$4,000 gross income x 36% = $1,440 expenses and debt

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

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Income qualification

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

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

Section 13 – Part 2

SLIDE 1

Cash qualification

Since a lender lends only part of the purchase price of a property according to the lender's loan-to-value ratio, a lender will verify that a borrower has the cash resources to make the required down payment.

If some of a borrower's cash for the down payment comes as a gift from a relative or friend, a lender may require a gift letter from the donor stating the amount of the gift and lack of any requirement to repay the gift.

On the other hand, if someone is lending an applicant a portion of the down payment with a provision for repayment, a lender will consider this another debt obligation and adjust the debt ratio accordingly.

This can lower the amount a lender is willing to lend.

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Net worth

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

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Credit evaluation

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

Outstanding debts	Payment behavior (timeliness, collection problems)
Legal information of public record (lawsuits, judgments,	Bankruptcies, divorces, foreclosures, garnishments, repossessions, defaults)

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

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Credit evaluation

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

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