Real Estate Finance

Lesson 8

Mortgage Loan Origination, Processing, and Servicing – Part 2

45 Hour Louisiana Post-Licensing

10/14

Qualifying the Title

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

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. The discussion which follows generally assumes a loan closing in which title rights are also 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. This type 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 being 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, a number of different parties are responsible for carrying out various tasks that are individually and collectively necessary and important. Those with specific responsibilities include the seller, buyer, lender, attorney, broker and escrow agent (title company), if different from the attorney. 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.

Sellers are typically responsible for having the deed prepared in accordance with the quality of title agreed upon in the sales contract. The seller is responsible for removing or remedying title defects that are not in accord with the promised title quality, particularly those which may not appear in the legal record. If a mortgage lien exists, the seller must arrange to have it cancelled at the closing when the proceeds of the sale are used to repay the outstanding loan balance. If the property is to be sold subject to, or with the assumption of an existing loan, the necessary arrangements with the lender must be made by the seller to see that proper documentation is provided to the lender. It may be the seller's responsibility to obtain a termite or other pest control assurances from a bonded company stating that the property is free of wood destroying "critters". The seller may be responsible for paying any outstanding property taxes, or other public charges levied against the property, and securing the appropriate receipts. The sales contract may require that the seller produce a copy of any existing title insurance policy, the bills of sale for any personal property to be conveyed, and a copy of the most recent boundary survey of the property. Additionally, sellers are required to produce those items necessary for the buyer to gain access to the property such as door keys, garage door opener remote controls, and keys to open any auxiliary buildings on the property.

Buyers are responsible first and foremost for satisfying in good faith any contingencies or predications which they included as part of the purchase agreement. The predominant condition usually involved securing financing under the terms and conditions of the contract. This involves actively searching the market for a loan that falls within the limits established, making formal application, submitting to a credit check and other requirements of loan qualification, and having the property appraised. The buyer is responsible for obtaining a title opinion and securing the necessary title insurance if required by the lender. If the title opinion reveals previously undisclosed defects, it is the buyer's responsibility to notify the seller to that effect. The buyer is responsible for having the subject property surveyed to verify boundaries, and identify any encroachments or easements not previously disclosed. Additionally, the buyer is responsible for obtaining property and casualty insurance on the improvements, naming the mortgagee as beneficiary, and for having the property inspected to identify physical defects in structural components such as the roof, foundation, plumbing, mechanical or electrical systems, or appliances.

The lender is responsible for processing the loan application in a timely manner, for ordering the credit reports and property appraisal, and for preparing the promissory note, mortgage document, as well as all disclosure documents required under federal or state law. The preparation of these documents is coordinated with the closing attorney. The lender is responsible for producing the necessary checks for disbursement of loan proceeds.

In addition to the title opinion and document preparation and review, an attorney, or closing agent, is usually responsible for explaining agreements that each party signs, and reciting the terms of the conveyance, mortgage and promissory note. The attorney is responsible for having documents signed by the appropriate parties, witnessed and notarized. When the closing is completed, the attorney is responsible for having the deed and mortgage recorded, and for providing copies of these documents to the appropriate parties. The attorney also handles the recordation of any documents necessary to cancel any outstanding liens or other claims against the title which are satisfied at the closing.

Most, if not all, of the closing process is guided by the Real Estate Settlement and Procedures Act (RESPA) which was previously discussed. In effect, it is the "law of the land" for virtually all real estate transactions and, among other things, helps to ensure an orderly procedure for a transaction that too many can appear complicated, clumsy, and often very confusing. Although it is rather demanding for lenders, it provides a level of assurances for all parties that help to reduce, if not eliminate, any subsequent claims of wrongdoing that could be costly to defend in court.

RESPA, as previously discussed, was enacted with the intention of ensuring full and fair disclosure of all costs involved in real estate transaction prior to, and at the closing. RESPA requires the use of the HUD-1 disclosure statement form, and its preparation and availability for review by the participants one working day before the date of the scheduled closing. RESPA also requires that all loan applicants be provided with a HUD information booklet explaining the closing and settlement process at the point of loan application. It also requires that at the loan application stage, the lender prepare good faith estimates of the total closing costs that the borrower will incur. RESPA prohibits lenders from paying referral fees or kickbacks to real estate brokers, attorneys, and others in return for steering the buyer/borrower to the lender or its affiliates. It also prohibits the lender from requiring the borrower to purchase title insurance from a particular company, and places limitations on the amount that lenders may require as escrow payments for casualty insurance and property taxes.

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

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: a) Originate, Hold and Service; b) Originate, Sell and Service; or c) Originate, Sell and Service Release.

- **<u>The Originate, Hold and Service Option</u>** 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 are credited to the customer's account, escrows are credited accordingly, and 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

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

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. Also, legislation passed in 1998 requires lenders to remove PMI requirements after the LTV on the loan drops to 78% or lower.

The Fixed Obligations or Back End Ratio

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

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.

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

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

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. Seller provided down payment assistance is allowed, but is limited now to 3% of the purchase price of the home, and must be made toward specific allowable closing costs.

Income Qualification Ratios

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

Compensating factors may be taken into consideration by the loan underwriter if an applicant’s front end ratio exceeds 31%. Among these factors are the borrower’s ability to make a larger down payment, relatively little non-housing related long term debt, minimal use of credit cards, good to excellent employment history, the potential for earning supplemental income, and a history of making higher than required monthly payments on existing or previously extended housing loans.

A Mortgage Insurance Premium (MIP)

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 as of April 2010 was 2.25% 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 on October 4, 2010 reduced the up-front MIP to 1.00%, 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

Conforming government guaranteed non-conventional loans in the arena of home mortgage lending are almost exclusively the focus and intent of Veterans Administrational (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

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

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.

Certificate of Eligibility

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. Effective January, 2005, 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.

Qualifying Ratio for VA Loans

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. This 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.

Funding Fee

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

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 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.

Assumption of VA Loans

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.

Certificate of Reasonable Value

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.