

REAL ESTATE FINANCE

Dynasty School

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This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. Although a great deal of care has been taken to provide accurate and current information, the ideas, suggestions, general principles and conclusions presented in this text are subject to local, state and federal laws as regulations, court cases and any revisions of same. The reader is urged to consult legal counsel regarding any points of law. This publication should not be used as a substitute for competent legal advice.

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PREFACE

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

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

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

HOW TO USE THIS BOOK

Read the text of each chapter. At the end of each chapter there are quizzes that challenge you to use what you have learned to solve problems involving practical applications of the knowledge gained. After you complete a test, check the answer key provided.

One cannot overestimate the growing importance of the Internet to the real estate industry. Its resources have brought together the interests of agents, consumers and investors. Throughout this book you will find addresses on the World Wide Web, a collection of computer sites referred to in this book as the  **web**.

The web has made the Internet easily accessible to anyone with a computer and Internet access. There are web sites sponsored by government agencies, sites run by private trade groups and others that are commercial enterprises all offer a great deal of free information that is both interesting and useful.

We encourage you to explore the sites mentioned in this book. To make it easy to find site references, they are highlighted in the margins of the text.

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CHAPTER 1: IMPORTANCE OF REAL ESTATE FINANCE



PREVIEW

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

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

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

HISTORY OF FINANCING

LAND – THE UNDERLYING BASIS OF WEALTH

Real estate in the form of land and improvements comprises a substantial amount of the total net worth of the United States., The real estate industry is a major employer, providing billions of dollars in income for millions of American workers and investors. When mortgage funds are

scarce, real estate activity and employment decline, and negative effects are felt throughout the economy.

FINANCING PRIOR TO THE 1930S

Sophisticated methods have developed for translating land's value into market transactions. But until well into the 20th century, financing was not highly developed or systematized.

FINANCING SINCE THE 1930S

The Great Depression meant monumental changes in financing. As the depression caused massive foreclosures and a massive devaluation of real property, there emerged the first comprehensive research into land use, real estate valuation, and the financing of real property.

GOVERNMENT PARTICIPATION

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

- ♦ **FEDERAL HOUSING ADMINISTRATION** (FHA, 1934) – The long-term amortized loan developed by FHA brought about a profound change in home and farm financing.
- ♦ **Federal Home Loan Bank Board** (FHLBB, 1932) – The credit reserve system of the FHLBB added to the stability of the savings and loan industry.
- ♦ **Federal Deposit Insurance Corporation** (FDIC, 1934) – The federal insurance of deposits in commercial banks ended the banking crisis of the Great Depression and restored public confidence in banks. Banks still sometimes fail, but since the establishment of the FDIC, no depositor has ever lost money in an FDIC-insured account.
- ♦ **Federal Savings and Loan Insurance Corporation** (FSLIC, 1934) – The federal insurance of deposits in savings and loan associations restored public confidence in the S&L industry.
- ♦ **Federal National Mortgage Association** (FNMA, 1938) – The secondary mortgage money market created by FNMA stimulated the primary mortgage money market by providing lenders an organized system for selling existing loans, and making money available for more loans in more areas. Via "Fannie Mae" the federal government laid the foundation for the modern secondary mortgage money market.
- ♦ **Government National Mortgage Association** (GNMA) – "Ginnie Mae" assumed some of Fannie Mae's riskier functions

in 1968, when Fannie Mae was converted to a stockholder-owned corporation.

- ♦ **Professional Standards** – The real estate industry began establishing professional standards, especially in the areas of property valuation and management. Professionals provided the professional management of properties they acquired through foreclosures and defaults.

HOUSING CYCLES

The housing cycle is irregular and wild, with great booms followed by falls. Several "boom times" in real estate occurred in the early 1960s, 1971-1973, 1975-1979, 1982-1989, and the late 1990s and early 2000, 2000-2006s and 2013-2017s. Between these periods were some bad years, such as 1966, 1969, 1974, 1980-1981, as well as severe housing crash from 1990 to 1996. 2008-2011 in many parts of California.

What causes a bust in the real estate market? Reasons can include high interest rates, government deficits, and better investment opportunities. This causes "**DISINTERMEDIATION**" is the sudden flow of funds out of thrift institutions (who grants real estate loans) into the general money market (where real estate loans are uncommon). This drying up of real estate funds causes havoc in the housing market. Real estate activity is directly tied to the availability and cost of mortgage funds and to the general state of the economy. As these two items shift up and down, so goes the real estate market.

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

RECENT DEVELOPMENTS

For the last 35 years, changes in the real estate business have prompted an increasingly businesslike approach to financing.

- ♦ **Appraisal** – Appraisal techniques for property valuation have become sophisticated.
- ♦ **Alternative Financing** – More flexible and creative methods have evolved to provide ways of financing real estate.
- ♦ **Long-Term Amortized Loan** – The traditional fixed rate long-term (25-30 years) amortized loan has become less

prevalent because of fluctuating interest rates and periods of tight money markets.

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

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

Example:

A \$100,000 loan at an interest rate of 10% -- 30 years vs. 40 years

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

For the homebuyer who does not expect to own the property for an extended period, the \$28.43 monthly reduction in principal and interest payment could be the difference between qualifying and not qualifying, and may be well worth the additional interest over the short term.

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

Real Estate Debt in the last few decades has increased significantly.

Tax Structure – Changes in the tax codes have made real estate an attractive investment.

THE 1989 S&L BAILOUT

The Savings and Loan Crisis was the most significant bank collapse since the Great Depression of 1929.

"Insanity" Factor – To attract new business, S&Ls on the brink of failure offered home loans at unrealistically low rates. Concurrently, they paid higher-than-normal interest rates to attract cash at a time when many

depositors were withdrawing cash because of the fear of financial unsoundness. Meanwhile, financially healthy institutions had to compete with the lower mortgage rates and higher deposit rates, cutting deeply into profits. One economist described such unsound business practices as the "**insanity factor**."

In the 1970s, stagflation combined low economic growth with high inflation. The Federal Reserve raised interest rates to end double-digit inflation. That caused a recession in 1980.

Following the 1980 "deregulation" of the savings and loan industry, many S&Ls began aggressive expansion into riskier investments, opening the doors to the excesses of greed and fraud. By 1989, more than 1,000 of the nation's savings and loans had failed. Between 1986-1995, more than half of the nation's S&Ls had failed.

The sick thrifts had little to lose if they failed. The federal government would take over and pay each depositor up to the \$100,000 insured limit.

Stagflation and slow growth devastated S&Ls. Their enabling legislation set caps on the interest rates for deposits and loans. Depositors found higher returns in other banks.

At the same time, slow growth and the recession reduced the number of families applying for mortgages. The S&Ls were stuck with a dwindling portfolio of low-interest mortgages as their only income source.

The situation worsened in the 1980s. Money market accounts became popular. They offered higher interest rates on savings without the insurance. When depositors switched, it depleted the banks' source of funds. S&L banks asked Congress to remove the low interest rate restrictions. The Carter Administration allowed S&Ls to raise interest rates on savings deposits. It also increased the insurance level from \$40,000 to \$100,000 per depositor.

In 1982, President Reagan signed the Garn-St. Germain Depository Institutions Act. It solidified the elimination of the interest rate cap. In particular, the law removed restrictions on loan-to-value ratios. It permitted the S&Ls to use federally-insured deposits to make risky loans. At the same time, budget cuts reduced the regulatory staff at the FHLBB. This impaired its ability to investigate bad loans.

The Rescue – In 1989, Congress passed and the President signed, the \$160 billion financial rescue, the largest in the nation's history.

The crisis cost \$160 billion. Taxpayers paid \$132 billion, and the S&L industry paid the rest. The Federal Savings and Loan Insurance Corporation paid \$20 billion to depositors of failed S&Ls before it went bankrupt.

More than 500 S&Ls were insured by state-run funds. Their failures cost \$185 billion before they collapsed. The crisis ended what had once been a secure source of home mortgages. It also destroyed the idea of state-run bank insurance funds.

THE 2008 GLOBAL FINANCIAL CRISIS

WHAT REALLY CAUSED THE CRISIS?

The 2008 global financial crisis was primarily caused by deregulation in the financial industry. That permitted banks to engage in hedge fund trading with derivatives. Banks then demanded more mortgages to support the profitable sale of these derivatives. They created interest-only loans that became affordable to subprime borrowers.

In 2004, the Federal Reserve raised the fed funds rate just as the interest rates on these new mortgages reset.

Housing prices started falling as supply outpaced demand. That trapped homeowners who couldn't afford the payments, but couldn't sell their house. When the values of the derivatives crumbled, banks stopped lending to each other. That created the financial crisis that led to the Great Recession.

DEREGULATION

In 1999, the Gramm-Leach-Bliley Act allowed banks to use deposits to invest in derivatives. Bank lobbyists said they needed this change to compete with foreign firms. They promised to only invest in low-risk securities to protect their customers.

The following year, the Commodity Futures Modernization Act exempted credit default swaps and other derivatives from regulations. This federal legislation overruled the state laws that had formerly prohibited this from gambling. It specifically exempted trading in energy derivatives.

Who wrote and advocated for passage of both bills?

Texas Senator Phil Gramm, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs. He listened to lobbyists from energy company, **Enron**. His wife, who had formerly held the post of Chairwoman of the Commodities Future Trading Commission, was an

Enron board member. Enron was a major contributor to Senator Gramm's campaigns.

Federal Reserve Chairman Alan Greenspan and former Treasury Secretary Larry Summers also lobbied for the bill's passage.

Enron wanted to engage in derivatives trading using its online futures exchanges. Enron argued that foreign derivatives exchanges were giving overseas firms an unfair competitive advantage.

Big banks had the resources to become sophisticated at the use of these complicated derivatives. The banks with the most complicated financial products made the most money. That enabled them to buy out smaller, safer banks. By 2008, many of these major banks became too big to fail.

SECURITIZATION

How did securitization work? First, hedge funds and others sold mortgage-backed securities, collateralized debt obligations, and other derivatives. A mortgage-backed security is a financial product whose price is based on the value of the mortgages that are used for collateral. Once you get a mortgage from a bank, it sells it to a hedge fund on the secondary market.

The hedge fund then bundles your mortgage with a lot of other similar mortgages. They used computer models to figure out what the bundle is worth based on several factors. These included the monthly payments, total amount owed, the likelihood you will repay, and future home prices. The hedge fund then sells the mortgage-backed security to investors. Since the bank sold your mortgage, it can make new loans with the money it received. It may still collect your payments, but it sends them along to the hedge fund, who sends it to their investors. Of course, everyone takes a cut along the way, which is one reason they were so popular. It was basically risk-free for the bank and the hedge fund.

The investors took all the risk of default. But they didn't worry about the risk because they had insurance, called **credit default swaps**. These were sold by solid insurance companies like the American International Group. Thanks to this insurance, investors snapped up the derivatives. In time, everyone owned them, including pension funds, large banks, hedge funds, and even individual investors.

Some of the biggest owners were Bear Stearns, Citibank, and Lehman Brothers.

A derivative backed by the combination of both real estate and insurance was very profitable. As the demand for these derivatives grew,

so did the banks' demand for more and more mortgages to back the securities. To meet this demand, banks and mortgage brokers offered home loans to just about anyone. Banks offered **subprime mortgages** because they made so much money from the derivatives, rather than the loans themselves.

THE GROWTH OF SUBPRIME MORTGAGES

In 1989, the Financial Institutions Reform Recovery and Enforcement Act increased enforcement of the Community Reinvestment Act. This Act sought to eliminate bank "redlining" of poor neighborhoods. That practice had contributed to the growth of ghettos in the 1970s. Regulators now publicly ranked banks as to how well they "greenlined" neighborhoods. Fannie Mae and Freddie Mac reassured banks that they would securitize these subprime loans.

That was the "pull" factor complementing the "push" factor of the CRA.

THE FED RAISED RATES ON SUBPRIME BORROWERS

Banks hit hard by the 2001 recession, welcomed the new derivative products. In December 2001, Federal Reserve Chairman Alan Greenspan lowered the fed funds rate to 1.75 percent. The Fed lowered it again in November 2002 to 1.25 percent.

That also lowered interest rates on adjustable-rate mortgages. The payments were cheaper because their interest rates were based on short-term Treasury bill yields, which are based on the fed funds rate. But that lowered banks' incomes, which are based on loan interest rates.

Many homeowners who couldn't afford conventional mortgages were delighted to be approved for these interest-only loans. As a result, the percentage of subprime mortgages doubled, from 10 percent to 20 percent, of all mortgages between 2001 and 2006. By 2007, it had grown into a \$1.3 trillion industry. The creation of mortgage-backed securities and the secondary market ended the 2001 recession.

It also created an asset bubble in real estate in 2005. The demand for mortgages drove up demand for housing, which homebuilders tried to meet. **With such cheap loans, many people bought homes as investments to sell as prices kept rising.**

Many of those with adjustable-rate loans didn't realize the rates would reset in three to five years. In 2004, the Fed started raising rates. By the end of the year, the fed funds rate was 2.25 percent. By the end of 2005, it was 4.25 percent. By June 2006, the rate was 5.25 percent. Homeowners were hit with payments they couldn't afford. These rates rose much faster than past fed funds rates.

Housing prices started falling after they reached a peak in October 2005. By July 2007, they were down 4 percent. That was enough to prevent mortgage-holders from selling homes they could no longer make payments on. The Fed's rate increase couldn't have come at a worse time for these new homeowners. The housing market bubble turned to a bust. That created the banking crisis in 2007, which spread to Wall Street in 2008. (Sources: "The S&L Crisis: A Chrono-Bibliography," FDIC. "The Savings and Loan Crisis and Its Relationship to Banking," FDIC.gov.)

THE IMPORTANCE OF FINANCE TO REAL ESTATE

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

REAL ESTATE FINANCE

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

DEVELOPMENT

Financing makes the projects of contractors and developers possible.

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

REAL ESTATE BROKERAGE

Financing makes sales possible for new and existing properties.

- ♦ The price of a property is influenced by the financing available, which affects the down-payment amount and the number of buyers capable of qualifying for loans.

- ♦ Many buyers "shop" financing terms even more than sale price. Their ability to purchase depends primarily on their ability to afford the monthly loan payments.

PROPERTY MANAGEMENT

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

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

THE PUBLIC

- ♦ **Home Buyers** – Purchasing a home is the major investment for most families, and a cash purchase is generally impossible. When property values rise, the availability of financing determines, more and more, whether or not homes can be purchased.
- ♦ **Investors** – Frequently, income property is purchased to take advantage of leverage. **LEVERAGE** is *using others money to the maximum extent*. Without financing, leverage is impossible.
- ♦ **Refinancing** – The public provides an enormous demand for money through refinancing.

GOVERNMENT INVOLVEMENT

Governments exert an enormous influence on finance at different levels, affecting the cost and availability of funds for real property.

- ♦ **Regulations** – Regulations on interest and loan broker commission rates directly affect how much the borrower pays for money.
- ♦ **Monetary and Fiscal Policies** – Government spending, tax policies, and regulation of the money supply all affect the availability of mortgage money, and the prevailing interest rates.
- ♦ **Land Use** – Local controls on growth and density, and environmental restrictions on uses of property affect the cost of developing real estate, the demand for real estate, and the willingness of lenders to finance.

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

THE IMPORTANCE OF FINANCING TO THE REAL ESTATE LICENSEE

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

- ♦ **Residential Sales** – Sales of new and existing properties generally depend upon the availability of satisfactory financing.
- ♦ **Income Property Sales** – Because of the importance of cash flow and leverage, income property sales are almost entirely dependent upon the arrangement of financing satisfactory to both the buyer and seller. This may involve:
 - Primary financing – First mortgage loans.
 - Secondary financing, from the seller or outside lender.
 - "Wraparound" or all-inclusive trust deed is a method by which a seller may extend credit while selling property subject to an existing loan.
 - Installment sale is a method of income-tax reporting by which a seller spreads capital gain tax over a period of time.
 - Tax-deferred exchange is a method of exchanging a property rather than selling in order to postpone the capital gains tax.

PROPERTY MANAGEMENT

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

LOAN BROKERAGE

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

advantage of the many services available from loan brokers and mortgage bankers.

LOAN TYPES

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

- ♦ **Government backed loans** - These are made by approved institutions and mortgage companies and *insured* by the federal government. These loans must be written to FHA specifications.
 - **HUD/FHA** - These loans are made by approved institutions and mortgage companies and *insured* by the federal government. These loans must be written to FHA specifications.
 - **DVA** - These loans are made by approved institutions and mortgage companies and *guaranteed* by the federal government. They must be written to DVA specifications.
 - **Cal-Vet** - These loans are made by the State of California, Department of Veterans Affairs. They are for California veterans only, and the borrower must meet DVA's strict requirements at the time the loan is made and subsequently.
Government backed loans (FHA/DVA/Cal-Vet) will be discussed in details in Chapter 5.
- ♦ **Conventional** - Conventional loans are usually written **conforming** to FNMA (Fannie Mae) practices and limitations, and are also called "**CONFORMING LOANS.**" These loans are made by institutions and mortgage companies with the expectation of selling the loans to either FNMA or FHLMC.

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

Conventional loans will be discussed in details in Chapter 6.

CHAPTER 1 QUIZ

1. Knowledge of real estate finance is not necessary for the person who plans to specialize in:
 - A. Property management
 - B. Appraisal
 - C. Loan brokerage
 - D. None of the above
2. Government influence in real estate financing is at all levels:
 - A. Becoming more involved
 - B. Becoming less involved
 - C. Stagnant
 - D. None of the above
3. Prior to the mid-1930s, most real estate financing was:
 - A. Fully amortized over the life of the loan
 - B. Partly amortized with a large balloon payment
 - C. A straight note payable interest-only, with the original loan payable in full at end of the note period
 - D. None of the above
4. Which of the following is not a federal government agency established for real estate financing?
 - A. Federal Housing Administration
 - B. Federal Home Loan Bank Board
 - C. Federal Bank Board Administration
 - D. Federal National Mortgage Association
5. One of the most significant changes in the mortgage money market in the mid-1930s was:
 - A. The availability of unlimited funds for mortgage financing
 - B. A secondary money market for mortgage notes on a nationwide basis
 - C. The absolute control of mortgage financing by the federal government
 - D. The rise of non-standard methods of appraisal and property valuation throughout the United States

6. The relatively sudden flow of funds out of thrift institutions into the stock market is called
 - A. Reverse annuity.
 - B. Disintermediation.
 - C. Re-intermediation.
 - D. Variable annuity.
7. As a result of the high foreclosure rates during the Great Depression, the real estate industry made significant progress toward professionalization in the areas of property management and valuation. This was due to:
 - A. The need by lenders for expert management of properties they acquired through default
 - B. New government regulation of the real estate industry
 - C. Buyer rejection of the old methods
 - D. The introduction of the "Code of Ethics" by the NAR
8. Financing is important to the real estate industry in terms of:
 - A. Property management
 - B. Real estate brokerage
 - C. Land development
 - D. All of the above
9. As security for a loan, land is often a sound basis for collateral due to its:
 - A. Fixed location
 - B. Non-susceptibility to government regulation
 - C. Indestructibility
 - D. Both A and C.
10. An advantage to obtaining a loan to buy property is to:
 - A. Avoid attorney fees
 - B. Utilize leverage
 - C. Avoid the loan being sold to the secondary mortgage market
 - D. None of the above

Chapter 1 Answers: 1-D, 2-A, 3-C, 4-C, 5-C, 6-B, 7-A, 8-D, 9-D,

10-B

CHAPTER 2: THE MONEY MARKET



PREVIEW

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

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

MONEY & THE MONEY SUPPLY

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

Definition

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

☞ Our monetary system is based on standards of confidence.

☞ Our money system can be categorized as M1, M2 or M3.

- ♦ **M1** is the sum of currency held by the public, in the form of coins, cash, or traveler's checks.
- ♦ **M2** is M1 plus savings accounts and small-denomination time deposits (less than \$100,000), plus shares in money market

mutual funds (other than those restricted to Institutional investors), overnight Euros and repurchase agreements.

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

MORTGAGE MONEY - SUPPLY AND DEMAND

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

SUPPLY

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

- ♦ **Direct** - Savings are invested in mortgages directly by the saver or through a loan broker. This method accounts for a substantial portion of all mortgages and trust deeds in the United States.
- ♦ **Indirect** - Savings deposits are invested in the mortgage market through an intermediary such as a bank, savings and loan, insurance company, REIT, or other syndication. Usually the saver is not aware of the investment since the main concern is safety and interest rate.

INFLUENCES ON SUPPLY

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

- ♦ **Competition for Supply** - *Where* surplus money goes greatly depends upon who is willing to pay the most for its use. Those needing the money will bid for its use. According to the law of supply and demand, it will go to the highest bidder.
- ♦ **Effect on Mortgage Funds** - How much money goes into the mortgage market depends on the interest offered for the use of the money and the total supply of money available. Traditionally, when money is "tight" the real estate market

loses it to other users of money (markets) as they will bid higher interest based on use for a shorter term.

DEMAND FOR MORTGAGE MONEY

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

NEW CONSTRUCTION

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

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

- ♦ **Owner-Builder Work** - An owner acts on his own behalf rather than through a general contractor and hires contractors ("subs") to handle the work. Heavy construction jobs done by major corporations or by government agencies often use this method.
- ♦ **Speculation** - Most housing tracts and many commercial and industrial buildings are constructed at the contractor's own expense in hopes of selling at a profit after completion.

SALE FINANCING

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

REFINANCING

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

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

STRENGTH OF DEMAND

International, national, local and institutional factors all affect the strength of demand for mortgage money. Effective demand is demand backed by ability to pay.

Two major factors affecting the strength of effective demand are:

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

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

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

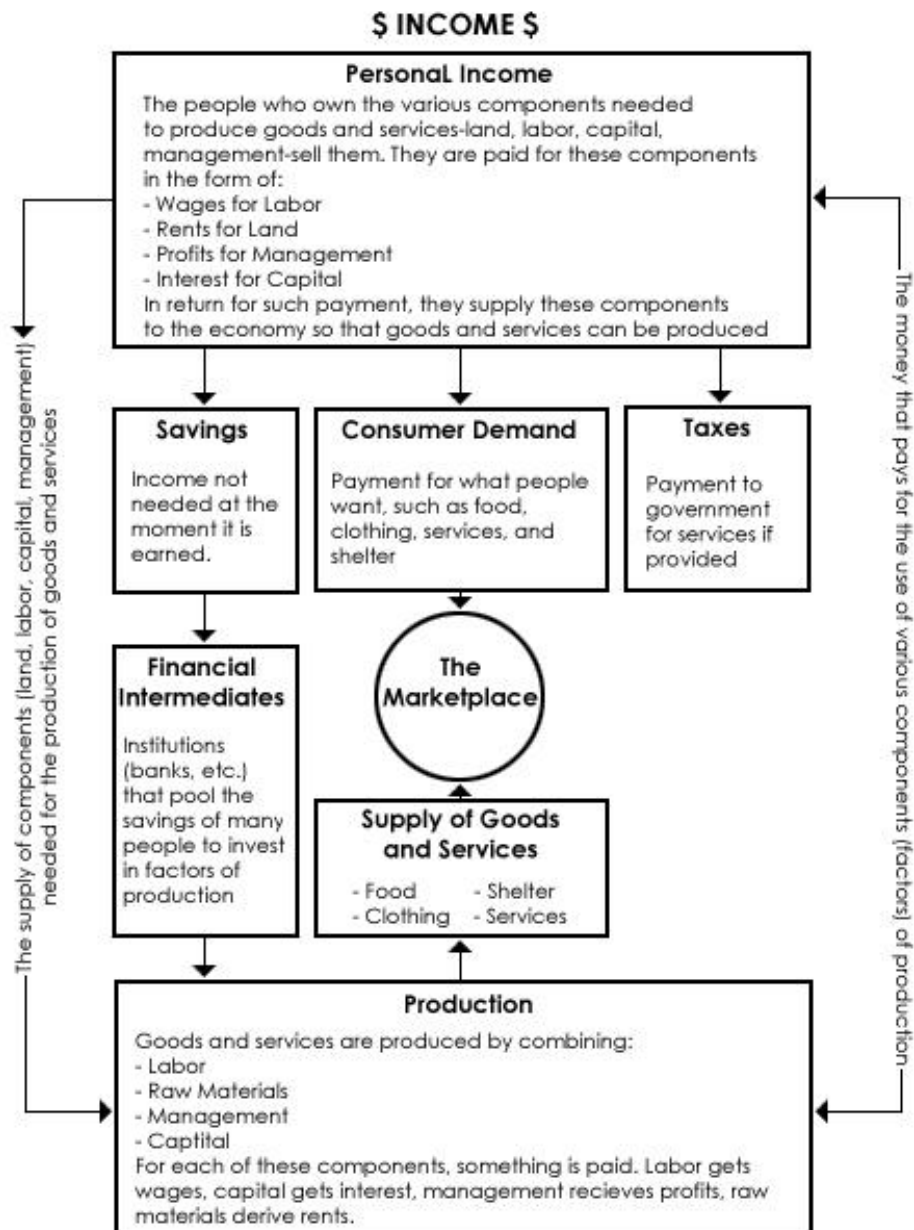
THE FLOW OF MONEY

Real estate financing occurs through a process called the "**flow of money**."

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

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

Figure 2-1: The Flow of National Economy



INTERMEDIATION AND DISINTERMEDIATION

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

The opposite of intermediation is **DISINTERMEDIATION**. This is the taking out or the withdrawal of funds from the institutional lender and the reinvesting in another savings instrument with a higher yield.

Disintermediation happened during the recession of 1979-1982. Depositors were withdrawing their savings from the savings associations in record amounts in order to try to keep up with inflation. The term was frequently used during the recession, and it has a great impact on the real estate market. The more disintermediation, the fewer funds available to real estate. Now that we have some idea of what an institutional lender is, let's see how mortgage loans are distributed among the institutional lenders.

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

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

REINTERMEDIATION

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

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

COST FACTORS OF MORTGAGE MONEY

Money and credit are commodities. The cost of money depends on supply and demand because it is bought, sold, and leased like any other commodity. The following are factors affect cost.

INTERNATIONAL FACTORS

The world's economies are so interdependent that the mortgage money market in the U.S. must be considered in an international context.

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

NATIONAL FACTORS

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

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

- ♦ **Prosperity** - Expansion and good times.
- ♦ **Recession** - Conditions turning downward.
- ♦ **Trough Or Depression** - Lowest point of a contraction, after which conditions turn upward for a period of recovery.
- ♦ **Recovery** - Conditions turning upward.
- ♦ **Types And Lengths Of Cycles** - Major business cycles can last from 6 to 13 years. Minor cycles may last 2 to 9 years. Usually real estate cycles and business cycles do not coincide. Generally, the real estate market decline precedes the decline in the business activity cycle. Conversely, the tendency of the business cycle is to recover prior to the real estate cycle.

Figure 2-2: Business Cycle



CAUSES OF THE BUSINESS CYCLE

Many variables effect the movement of the business cycle. They include:

- ♦ **Internal Influences** - Some influences are directly economic in nature, resulting from regulatory and market activities.
 - Government Policy** - The government has extensive influence on:
 - Monetary Conditions** - Interest rate and credit availability.
 - Spending** - Saving and investment vs. consumption.
 - Taxes** and government spending.
 - Market Psychology** - The human element. Consumers and investors will often act according to how they feel, despite what is actually happening.
 - Prices** - When prices increase faster than income levels, inflation is amplified and consumption is reduced.
- ♦ **External Influences** - Conditions which arise outside economic circles also affect the business climate, both nationally and locally.
 - **Weather** - Abnormal weather conditions, like prolonged cold spells or drought, can affect agriculture, transportation, and industrial production as well as public psychology.

- **Natural Disasters** - Earthquakes, hurricanes, floods, and fires present severe, unexpected strains on local resources, which may ripple throughout the economy.
- **War** - Causes increased military spending and affects allocation of industry and manpower.
- **Population** - Changes in the median age of the population affect consumption patterns. Migration into or out of a nation or locality is another powerful influence.

LOCAL FACTORS

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

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

INSTITUTIONAL FACTORS

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

- ♦ **Deposit Cost** - The cost of obtaining money from depositors, in order to have money to offer borrowers.
 - How much interest must savers be paid in order to attract their money into lending institutions?
 - What is the cost of advertising and promotion in order to attract savers?
- ♦ **Sales Cost** - The cost of marketing loans to borrowers.
 - What are the costs involved in attracting loans?
 - How much must be spent to attract good loan applications?
- ♦ **Administration** - How it is the cost to operate the institution, taking into account rent, utilities, salaries, overhead, etc.?
- ♦ **Reserves** - What legal reserves must be set aside?
- ♦ **Profit** - How much profit can reasonably be expected?

EFFECTS OF THE BUSINESS CYCLE

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

- ♦ **Employment** - During an upswing (recovery and prosperity), demand increases production, thereby increasing employment. During a downswing (recession and depression), employers decrease production due to lack of demand and employment decreases. Lower employment means less effective demand for all commodities, including mortgage money.
- ♦ **Inflation** - Inflation directly affects prices and the value of money, and has pervasive effects on public psychology as well as on spending patterns.
 - During an upswing, as the repressed demand is released, employers increase production to meet this demand, and employment is increased. In the interim, demand exceeds supply and prices increase, resulting in inflation.
 - During a downswing, when prices rise to a point where demand is no longer effective, supply will exceed demand and result in lower prices (deflation), and decrease in employment (some unemployment is considered necessary to curb inflation).
- ♦ **Stagflation** - A period of rapid inflation during a recessionary economy. It first appeared in the U.S. in the 1970s.

Consumption remains strong because of the fear of further price increases, while production falls behind because of the fear of recession, overstocking, and high operating costs.

FISCAL POLICY

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

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

CHARACTERISTICS OF REAL ESTATE

- ♦ **Local** - Each parcel of real estate is unique. So then is each real estate loan, as most lenders lend in their own local areas, and each risk must be individually evaluated.
- ♦ **Complex** - Each parcel of real estate, especially an improved parcel, is composed of many legal rights and interests. Any mortgage secured by this real estate becomes involved in these complexities.
- ♦ **Durable** - Real estate is virtually indestructible, and can be financed over a long period of time. The decision to purchase real property is generally a long-term commitment for the buyer and the lender.
- ♦ **Expensive** - Real estate, particularly improved real estate, is expensive because of its unique, durable, and complex nature and, requires a relatively large amount of mortgage money to purchase.

THE CALIFORNIA MORTGAGE MARKET

There are several characteristics of real estate which set it apart from other investments, and are reflected in the mortgage market. These

characteristics are all subject to local and regional variation, and California manifests them in unique ways.

WARMER, MILDER CLIMATE

- ♦ **High demand** - California has a large population with a fast growth rate and high demand. California is the most populous state, continues to attract new residents, and has a high birth rate. State officials estimate California's population to rise from their current 40 (2017) million to 60 million by 2040!

WIDE DIVERSIFICATION OF INDUSTRY AND AGRICULTURE

- ♦ **Diversity** - California's economy is one of the most diversified in the world and is constantly growing. Its mix of ethnic and social diversity is creating new opportunities for housing and financing.
- ♦ **Financial Institutions** - California contains the largest number of banks and thrift institutions, offering citizens a greater choice of lenders than do residents of other states.
- ♦ **Loan Correspondents** - California has attracted many experienced and diversified mortgage loan correspondents who represent out-of-state life insurance companies and other Institutional and non-institutional lenders. This brings additional mortgage money to California.

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

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

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

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

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

MONEY IN THE ECONOMY

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

Most of us take it for granted that money and credit conditions have important effects on our personal financial affairs and on the nation's economic performance. Despite that, many people are unsure how monetary policy affects our nation's economy and even less certain how it is carried out.

It begins by explaining what economists mean when they talk about "money," and how banks and other depository institutions can "create" money. It then covers how monetary policy is made in the United States and describes the policy instruments the Federal Reserve System has at its disposal to control the size of the money supply.. Next is a discussion of how Federal Reserve actions in making the money supply grow faster or slower affect interest rates, unemployment, and inflation. Finally, it covers the operating procedure used by the Federal Reserve to carry out monetary policy.

THE PROCESS OF MONEY CREATION

DEFINING MONEY

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

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

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

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

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

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

☞ A liquid asset is one which can be readily sold.

CREATING MONEY

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

Reserve requirements have not always been uniform across institutions. Prior to passage of the Depository Institutions Deregulation and Monetary Control Act in 1980, only banks that belonged to the Federal Reserve

System, called member banks, were subject to reserve requirements set by the system. Non-member banks, which accounted for approximately 30 percent of total demand deposits, were subject to the reserve requirement set by the states in which they were located. These state-mandated reserve requirements were on average lower than the Fed's requirements. More importantly, in many states, banks could include as reserves such assets as government securities over which the Federal Reserve had no control. Finally, thrift institutions were not subject to reserve requirements at all.

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

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

The multiple expansion or contraction of bank deposits in response to a change in the quantity of reserves occurs because banks and other depository institutions have the power to create new deposits and either lend them out to customers or use them to purchase investments such as government securities. If a bank decides that it is profitable to lend to a car dealer, for example, it credits the dealer's checking account at the

bank with the amount of the loan. Conversely, when the dealer repays the loan out of his checking account, the bank simply reduces the deposit correspondingly. Deposits, in other words, can be created and destroyed with the stroke of a pen, or perhaps more accurately in today's environment, by the stroke of a computer key.

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

MULTIPLE BANK SYSTEM

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

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

At this point, however, the second bank has \$1,000 of additional deposits and an equal amount of new reserves. This second bank, which must hold required reserves of $.10 \times \$1,000 = \$100$ against the increase in its deposits, has gained excess reserves of \$900. It, therefore, will try to make a new loan for \$900 and fund this loan by creating new deposits of \$900. The new money created up to this stage is \$1,000 + \$900 or

\$1900. The new borrower will draw on his new deposit to make purchases and the check will end up in other banks; the \$900 in excess reserves will be transferred to those other banks and they in turn will make new loans or investments by creating additional new deposits.

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

TOOLS OF MONETARY POLICY

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

COMPONENTS OF THE MONEY SUPPLY

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

OPEN MARKET OPERATIONS

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

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

BORROWINGS AND THE DISCOUNT RATE

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

Higher or lower discount window borrowing affects the total supply of reserves and thereby the amount of deposits banks and other depository institutions can support with a given provision of non-borrowed reserves. At times, fluctuations in borrowed reserves may pose a potential problem for monetary control by causing total reserves to diverge from the Federal Reserve's goals. To offset such changes in borrowing, the Fed may adjust the discount rate. Alternatively, to a degree, the Federal Reserve could offset the effects of variations in borrowed reserves by altering the supply of non-borrowed reserves.

The Federal Reserve sometimes uses discount rate changes for their "announcement" effects, as a way of signaling or announcing to markets a significant change in monetary policy. A higher discount rate can be used to indicate a more restrictive policy, while a lower rate may signal a more expansionary policy.

CHANGES IN RESERVE REQUIREMENTS

The Federal Reserve has a third monetary policy tool at its disposal - the power to change, within statutory limits, the reserve-requirement ratio. This ratio specifies the amount of reserves that depository institutions must have for each dollar of deposits. Changes in the ratio alter the dollar amount of reserves that depository institutions must hold against their deposits.

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

Reducing reserve requirement is equivalent to increasing the supply of reserves. It starts the process of multiple expansions of loans and deposits described earlier, and the process continues until the excess reserves have disappeared. An increase in reserve requirements is equivalent to a reduction in reserve supply, causing a multiple contraction in deposits outstanding.

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

MONETARY POLICY

The United States is unique in having a central bank that is federal rather than unitary in structure. Established in 1913, the Federal Reserve System consists of the Board of Governors in Washington, D.C., and twelve regional Federal Reserve Banks, which are the operating arms of the system. The Federal Reserve Bank of San Francisco represents the Twelfth District. Although primary responsibility for monetary policy rests with the Board, the Reserve Banks also have a role to play.

The Board of Governors consists of seven officials appointed to fourteen-year terms by the President of the United States and confirmed by the Senate. The Chairman of the Board is appointed by the President and serves for four years, but may be reappointed. The System meets its operating expenses primarily from the interest earnings from its portfolio of securities, and is not subject to the Congressional appropriations process. The founders of the Fed believed it was necessary to separate the people who frame the government's spending decisions and the people who control the supply of money, and devised the institutional structure with this view in mind.

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

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

The Board of Directors makes recommendations regarding the discount rate changes. Final approval rests with the Board of Governors, who also has sole authority with regard to reserve requirements.

OBJECTIVES OF MONETARY POLICY

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

Since the mid-1970s, the Federal Reserve has pursued an intermediate target strategy based on the monetary aggregates. Over this period M1 and M2 have been the Federal Reserve's principal targets. The Fed first

determines growth targets for these monetary aggregates that are thought to be consistent with its objectives for unemployment, inflation, economic growth, and a stable foreign exchange value for the U.S. dollar. It then uses the monetary policy instruments at its disposal to achieve the targeted growth in money, expecting that such growth will advance the economy toward the ultimate goals.

THE TRANSMISSION MECHANISM

Targeting the monetary aggregates makes sense only if the Federal Reserve can predict what effect these aggregates will have on the economy. The policy-maker needs to know the links between money and the objectives of monetary policy. The chain of reactions in the economy transmits changes in money growth to the levels of unemployment and inflations referred to by economists as the transmission mechanism.

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

Lower interest rates and a greater availability of credit tends to stimulate spending on durable goods of all kinds. As the rates investors can earn on financial instruments fall, yields on common stocks become more attractive, causing investors to bid their prices up. Households with stocks in their portfolios find that the value of their holdings has gone up, and this increase in their wealth prompts them to increase expenditures.

Higher expenditures raise output and employment, which stimulates business capital-goods spending even further by making greater demands on existing plant capacity. They also boost consumption because of the income gains resulting from the higher employment levels.

LAGS IN MONETARY POLICY

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

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

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

Many economists advocate what they call a "gradualist" policy of fighting inflation. Money growth is systematically slowed so that the adverse side effects on unemployment and output are minimized.

LONG-TERM POLICY

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

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

MONEY AND INTEREST RATES

Monetary growth has important consequences for interest rates. Monetary expansion at first reduces interest rates by expanding the supply of funds available for borrowing. But since monetary expansion very quickly leads

to an expansion in economic activity, business and households will increase their borrowing demands, and this will tend to reverse the initial fall in interest rates. Moreover, if high money growth persists, it will result ultimately in higher inflation. Then, lenders will demand a higher "inflation premium" in interest rates to protect the inflation-adjusted, or real, yields on their investments. Consequently, interest rates will tend to end up higher than their starting level- just the opposite of the short-run effect.

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

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

STRATEGIES AND OPERATING PROCEDURES

INDICATORS OF MONETARY POLICY

Setting targets for money growth is a recent innovation in the Federal Reserve's procedures. Money-growth targets were not adopted until the early 1970's. Before, the Fed, like most central banks, based monetary policy on interest rates. Lowering rates were taken as indications that monetary policy was being expansionary; higher interest rates were a sign that monetary policy was tight. The Fed's monetary policy instruments, open market operations, and the discount rate were used to adjust interest levels believed to be consistent with the ultimate objectives for inflation and unemployment. Thus, when the economy appeared to head towards inflation, open market operations were used to drain reserves and contract deposits and bank loans so that interest rates would rise. The rise in interest rates was expected to dampen spending and cool the economy. When the economy showed signs of slipping into recession, monetary policy focused on lowering interest rates to encourage spending and to forestall the downturn.

A MISLEADING INDICATOR

Toward the end of the 1960s, the Fed came to realize that interest rates could be misleading as an indicator. Rising interest rates, for example,

could be symptoms of strong credit demands fueled by a robust economy, or of rising inflation premiums as inflation began to heat up. In such cases, interpreting rising rates as signs of a restrictive monetary policy would be incorrect because they, in fact, would be signs that policy was inflationary. Similarly, falling interest rates could be symptoms of a weakening economy, not an expansionary monetary policy.

MONETARY TARGETING

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

FEDS RATE OPERATING PROCEDURE

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

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

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

The Fed Reserve can dampen money growth by exerting upward pressure on interest rates through open market sales to drain reserves; the higher interest rates would reduce the public's demand for money and cause monetary growth to slow. Downward pressure on interest rates can be expected ultimately to produce faster money growth.

SHIFT TO A RESERVES OPERATING PROCEDURE

While an improvement over the use of interest rates as indicators of monetary policy, the funds rate operating procedure is also flawed. It became evident that the funds rate was frequently slow to adjust to changing conditions, meaning money growth tended to speed up when the economy picked up, and to fall when the economy weakened.

To solve this problem, the Fed adopted a new operating procedure on October 6, 1979 seeking to achieve its money targets by placing less emphasis on interest rates and focusing more on the volume of reserves available to depository institutions. The new procedure placed more emphasis on controlling monetary growth by operating on the primary determinant of the supply of money: the volume of reserves that banks and thrifts have at their disposal.

An operating procedure focusing on reserves is subject various uncertainties stemming from variability in the average relationship between reserves outstanding and the amount of checkable deposits that will be created. This is called the "reserve multiplier" and depends on reserve requirements, among other things.

In the simple example of money creation in Section I, the multiplier was just the inverse of the required reserve ratio. In reality, things are a little more complicated. Because some liabilities of banks and thrifts other than checkable deposits also have reserve requirements, the amount of reserve available to support checkable deposits rises or falls depending on the outstanding amounts of those other reservable liabilities. A decrease in these other reservable liabilities would increase the amount of reserves that can support checkable deposits. Checkable deposits and the money supply can rise or fall even though total reserves outstanding are unchanged because the multiplier has changed.

A similar problem occurs when reserves are transferred among institutions with different reserve requirements because the size of an institution's reserve requirement determines the number of dollars that it can create per dollar of reserves.

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

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

THE DEMAND FOR MONEY

There is an alternate way to tell this story, which is to look at what happens to the supply of money--the total amount of cash balances held by the public. The increase in bank loans and investments is funded, among other ways, by banks creating new deposits. The fall in interest rates as banks expand loans and investments is associated with an increase in the supply of money to the economy. A smaller stock of money is associated with higher interest rates.

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

Economists call this the "*demand for money*."

The negative relationship between money demand and interest rates means that an increase in the amount of money circulating in the economy should lower interest rates, because if it did not, the public would find itself holding money in excess of what it wants to hold or "demand." If this money demand relationship is "stable" over time, monetary policy can be formed in terms of money supply targets. If the Fed wants to be more restrictive, it can set lower targets for the monetary aggregates because it can expect interest rates to rise and total spending in the economy to be dampened when these targets are hit.

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

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

The Fed responded to the first concern by implementing a major redefinition of the monetary aggregates in 1980. To address the second concern, they attempted to assess the impact of the new accounts on money demand, and to "adjust" the figures for money to take into account the change in the public's preferences for cash balances. In 1981 the Fed estimated that the nationwide introduction of NOW accounts raised the public's demand for money..

The actual growth in money of 5.1 percent for 1981 was adjusted to 2.2 percent in recognition that part of the growth in money during the year was simply to accommodate the public's increased preferences for money. The adjusted figure was a more accurate gauge of the impact of monetary policy on the economy.

CHAPTER 2 QUIZ

1. Money is:
 - A. Anything that serves as a generally accepted medium of exchange
 - B. Cash only
 - C. Coins only
 - D. Only the things backed by gold reserves
2. Components of the money supply include:
 - A. Commercial bank demand deposits
 - B. Currency in circulation
 - C. Coins
 - D. All of the above
3. A primary source of funds for residential financing is the:
 - A. Federal Home Loan Bank
 - B. Federal Savings and Loan Insurance Corporation
 - C. Federal Savings and Loan Association
 - D. Federal Housing Administration
4. Our present monetary system is based on a
 - A. Gold standard.
 - B. Gold reserve standard.
 - C. Silver standard.
 - D. Standard of confidence.
5. The Federal Reserve System has powers to control the flow of money and credit in the United States. All of the following are included in these powers **except**:
 - A. Establishment of the discount rate for member banks
 - B. Setting the reserve requirements for member banks
 - C. Buying and selling government securities
 - D. Control over the sale and purchase of municipal bonds and their interest rates
6. Business cycles have four phases:
 - A. Prosperity, recession, depression, recovery
 - B. Depression, recession, obsolescence, recovery
 - C. Progression, recovery, reaction, depression

- D. Obsolescence, depression, recovery, stagflation
7. When a business cycle begins to pick up after a downturn, this phase is called:
- A. Property
 - B. Recession
 - C. Depression
 - D. Recovery
8. "Stagflation" refers to:
- A. Inflation during an economic slowdown
 - B. Inflation during prosperity
 - C. A decrease in inflation during recession
 - D. A decrease in inflation during prosperity
9. The basic money supply consists of:
- A. Cash
 - B. Coins
 - C. Checking accounts
 - D. All of the above
10. When the Federal Reserve tightens up the money supply:
- A. The housing market is the last to feel the pinch
 - B. Housing sales increase
 - C. The use of seller carry-back financing declines
 - D. Mortgage interest rates usually increase

*Chapter 2 Answers: 1-A, 2-D, 3-C, 4-D, 5-D, 6-A, 7-D, 8-A, 9-D,
10-D*

CHAPTER 3: INSTITUTIONAL LENDERS



PREVIEW

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

INSTITUTIONAL LENDERS

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

There are several major types of institutions which participate in mortgage finance: *commercial banks, mutual savings banks and life insurance companies*. These institutions may be private, governmental, or quasi-governmental. Private individuals become important as (non-institutional) lenders when interest rates are high and alternative or junior financing is necessary to secure property transfers.

COMMERCIAL BANKS

A ***COMMERCIAL BANK*** functions as a depository for funds and a place from which to borrow money. They are not to be confused with "industrial

banks" or so-called finance companies. Commercial banks have two different forms of deposits, demand deposits and time deposits. The bulk of their funds are in ***demand deposits***, which are deposits in business and personal checking accounts. Rarely are such funds used for long-term mortgage lending, due to the highly volatile nature of such funds--they may be withdrawn on demand by the depositor and therefore cannot be depended on to remain in the account for very long. For this reason they are also referred to as transaction money or transaction accounts.

- ♦ **Type of institution** - Depository financial intermediary.
- ♦ **Time deposits** or *interest-bearing savings accounts* provide the bank with long-term funds that are invested into a variety of outlets, including real estate financing. Commercial banks may make almost any type of loan on virtually any type of reasonable collateral. Although their primary function is to make short-term business loans, California banks are aggressive participants in the home loan market.
- ♦ **Organization** - Commercial banks are stockholder-owned and subject to federal corporate income taxes. They may be chartered under either federal or state laws. Federally chartered or national banks are regulated by the Comptroller of the Currency, must be members of the Federal Reserve System, and have their deposits insured by the Federal Deposit Insurance Corporation (FDIC). State chartered banks may elect to belong to the Fed, in which case they are regulated by the Fed; or they may be insured and regulated by the FDIC. A few state chartered, non-member banks are regulated under state laws. Banks range in size from under \$5 million in assets to over \$100 billion.
- ♦ **Types of loans** - Commercial banks provide the most significant aid to housing through construction period loan funds advanced during construction and prior to permanent mortgage financing. Banks routinely account for over 40 percent of home construction loans, and the majority of apartment project loans.
- ♦ Commercial banks are a primary source for ***short-term construction financing***, when the builder or developer has a "take-out" commitment from some other lender--most often a savings bank--for the permanent mortgage loan following completion of improvements. Large commercial banks play a major role in financing business and commercial properties, while some smaller ones deal largely with home loans. Banks may make home loans up to 95 percent loan-to-value ratio,

for as long as 30 years on single-family dwellings. Many banks require private mortgage insurance on loans whose ratio of loan-to-value is in excess of 80 percent.

- ♦ Banks make ***swing loans***, sometimes referred to as ***bridge loans***, which are short-term interim loans used to bridge the time during which a property remains unsold. For example, if you as homeowner purchase a replacement house before selling the first house, a swing loan would provide the funds to fill the gap until the sale provides the funds to pay off the loan. Swing/bridge loans may have monthly payments or may be set up to be paid in a single lump sum upon sale of the old home.

SAVINGS BANKS (FORMERLY S&LS)

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

- ♦ **Type of institution** - Depository financial intermediary, together with Mutual Savings Banks (discussed below.) Classified as "thrifts."
- ♦ **Organization** - Savings banks may be either stockholder or mutually owned, and chartered under either state or federal laws.
- ♦ As a mutual institution, depositors and borrowers are given share certificates or receipts in return for deposits of money. This is why a deposit in a mutual thrift is often referred to as *a share liability* rather than *a savings deposit*. A capital stock institution, issues shares of stock to its investors, representing fractional shares of ownership of the institution.

FEDERAL CHARTERED OR STATE CHARTERED

Savings banks are members of the Federal Home Loan Bank system, are regulated by the FHLB Board, and must have their deposits insured by the FSLIC. State charters may be covered by FSLIC insurance (about three-quarters of them are, and all in California are insured); others may be insured by state funds. Savings banks may be grouped together with controlling stock interest held by a holding company; singly or in groups,

they may form service corporations which are allowed to carry out both investment and traditional service functions.

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

CHARACTERISTICS OF SAVINGS BANKS (THRIFTS)

PAST DEVELOPMENTS OF SAVING BANKS FROM S&LS

- ♦ Deregulation of Saving Banks -Financial deregulation during the 1980s freed S&Ls to participate in most of the activities traditionally limited to commercial banks.

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

Some S&Ls now use the term "bank" in their names. Some people see the commercial banks and the S&Ls essentially merging into one type of institution. However, the 1989 thrift industry "bailout" legislation has re-established many regulations for S&Ls.

- ♦ Mergers between thrifts, both inter-and intra-state, have reduced their number and created a few very large institutions. This has occurred both in rescue of troubled institutions, and to gain the financial clout to take advantage of new asset and service powers.
- ♦ Thrifts now have the power to offer commercial and consumer loans and make a variety of other investments directly or through their service corporations. Tax laws still require heavy mortgage investment for the special deduction, but some economists forecast a reduced home loan emphasis in the future.
- ♦ Government regulations require that a majority of their assets must be in real estate. Business and consumer loans are permitted to a limited extent. Most home loans do not exceed 95 percent of the appraised value or sales price of the home,

whichever is lower. Exceptions include government-backed loans, such as FHA and DVA. Most thrifts limit the maximum amount on a single loan to 1 percent of their total assets. Hence, larger thrifts are able to accommodate large loan requests more readily than smaller savings banks.

- ♦ Most thrifts limit their loans to 30 years, although 40-year loans are permitted in some cases. Fifteen-year loans are also widely promoted, especially in the home refinancing market. Sometimes, during periods of rising interest rates, many of these loans include provisions for due dates (balloons) in as few as three to five years, or for rollovers thereafter at the prevailing market rate. These have monthly payments amortized for 30 years, but the unpaid balance is due in three, five, or seven years.
- ♦ Interest rates in the past were highest among the institutional real estate lenders, due to the large demand for loans and the higher risks associated with higher *loan-to-value ratios*. (High loan-to-value means that the amount of the loan is high in relation to the appraised value or sales price of the property.) Currently, rates charged by commercial banks and savings banks are basically the same.
- ♦ Their basic real estate lending is on single-family, owner-occupied dwellings, but in a favorable market, thrifts will also finance mobile home loans, non-owner-occupied dwellings, apartments, and commercial and industrial properties.
- ♦ Combination loans are often available. Such loans combine construction (short-term financing) and *take-out loans* (long-term or permanent financing) into one loan.
- ♦ Savings banks are permitted to make collateral loans secured by the borrower's savings accounts, savings certificates, bonds, existing secured notes, and certain other forms of readily liquid assets.

S&LS VS. COMMERCIAL BANKS

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

THE 1989 S&L BAILOUT & 2008 FINANCIAL CRISIS

In 1989, the first Bush Administration bailed out the industry with the Financial Institutions Reform, Recovery, and Enforcement

Act. FIRREA provided \$50 billion to close failed banks. It set up the Resolution Trust Corporation to resell bank assets and use the proceeds to reimburse depositors.

FIRREA prohibited S&Ls from making more risky loans. Unfortunately, the savings and loan crisis destroyed confidence in banks that had once been thought to be secure sources of home mortgages because they were backed by state-run funds.

Like other banks, Savings and Loans were prohibited by the Glass-Steagall Act from investing depositors' funds in the stock market and high-risk ventures to gain higher rates of return. The Clinton Administration repealed Glass-Steagall Act to allow U.S. banks to compete with more loosely-regulated international banks. This allowed banks to use FDIC-insured deposits to invest in risky derivatives.

The most popular of these was the mortgage-backed security. Banks sold mortgages to Fannie Mae or Freddie Mac, who then bundled them and sold them to other investors on the secondary market.

Many hedge funds and large banks repackaged and resold them with subprime mortgages. They were insured against default by credit default swaps. The demand for these securities was so great that banks started selling mortgages to anyone and everyone.

All went well until housing prices started falling in 2006. Just like in the Depression, homeowners began defaulting on their mortgages, and the entire derivatives market collapsed. The 2008 financial crisis timeline recounts the critical events that happened in the worst U.S. financial crisis since the Great Depression.

Washington Mutual was the largest savings and loan bank in 2008. It ran out of cash during the financial crisis when it couldn't resell its mortgages on the collapsed secondary market. When Lehman Brothers went bankrupt, WaMu depositors panicked. They withdrew \$16.7 billion over the next 10 days. The FDIC took over WaMu and sold it to JPMorgan Chase for \$1.9 billion.

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

TRENDS IN THE SAVINGS BANK INDUSTRY

In 2013, there were only 936 Savings and Loans, according to the FDIC. The agency supervised almost half of them. Today, S&Ls are like any other bank, thanks to FIRREA.

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

MUTUAL SAVINGS BANKS

MUTUAL SAVINGS BANKS are *financial institutions* chartered by a *central* or regional government, without capital stock, that is owned by its members who subscribe to a common fund.

They fall between commercial banks and savings and loan associations in their investment policies. They have greater asset flexibility than the S&Ls and have reduced their lending for residential mortgages in recent years. Nonetheless, they remain the third largest lender group in residential mortgage holdings, behind S&Ls and commercial banks.

Mutual savings banks operate much like former savings and loan associations, but they exist chiefly in the northeastern United States.

☞ *None exist in California.*

LIFE INSURANCE COMPANIES

LIFE INSURANCE COMPANIES sell insurance policies and annuities and use the premiums paid plus reinvested dividends for investment.

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

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

Life insurance companies are chartered by states and operate under state insurance laws. They may be organized as either corporate or mutual companies.

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

While investment in residential mortgages by life insurance companies has been declining, they are an important source of funds for large, multi-million-dollar apartment and commercial projects. They also make significant purchases of mortgage-backed securities guaranteed by the GNMA. Life insurance companies are also important to non-residential mortgage lending.

CHARACTERISTICS OF LIFE INSURANCE COMPANIES

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

- ♦ Life insurance companies are less concerned with liquidity than with the safety and long-term stability of an investment. Therefore, they display a propensity to finance the larger real estate projects, leaving the smaller loans to other lenders.
- ♦ Loan-to-value ratios are apt to be on the conservative side, frequently less than 80 percent.
- ♦ Life insurance companies have the broadest lending powers of the Institutional lenders. Their investment policies are flexible and cover a wide range of financing activities. The laws governing life insurance company activities vary from state to state.
- ♦ Payback terms are long, usually 30-year amortizations, with occasional lock-in clauses that prevent a loan from being paid off before a specified date. For example, there might be a 10- or 15-year lock-in clause on a 30-year loan.
- ♦ Insurance companies prefer to grant large real estate loans (in the millions) as opposed to smaller residential home loans. Many major commercial and industrial developments have insurance company take-out loans.
- ♦ Construction loans are generally avoided. Instead, life insurance companies will make the take-out, or permanent, loan after the structure has been completed according to plans and specifications.

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

PENSION AND RETIREMENT FUNDS

A **PENSION FUND** is a fund set up by a corporation, labor union, government entity (teachers and government workers), or other organization to pay the pension benefits of retired workers. These funds invest billions annually in stocks, bonds, and real estate and are a major force regulating the supply and demand of the markets. Pension funds are usually tax deferred. An employee puts in monthly contributions without being taxed (which is being invested in stocks, bonds, and real estate). Employees are taxed on their pensions only when withdrawn. American workers insisted on plans that allowed them to set aside a portion

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

Pension and retirement funds have become potentially the largest sources of real estate financing. There are hundreds of thousands of private pension funds and state, local, and federal pension funds nationwide, representing over \$1 trillion in assets. The Mortgage Bankers Association of America projects the growth of these funds will create an enormous amount of potential mortgage funds.

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

Traditionally, pension funds have participated in the market place in two areas. The first of these is by direct investment in commercial real estate development. They are an important source of funds for developers and builders. The second of these are pension funds invested in the bond issues of the secondary market. However, the conservative managers of most funds have been unwilling to directly enter the mortgage lending

market.

According to a survey by the American Society of Real Estate Counselors, domestic pension funds are the leading source of direct investment funding for institutional-quality office buildings in the 2000s.

INDIVIDUAL RETIREMENT ACCOUNTS (IRAS) AND KEOGH PLANS

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

Until recently, most pension funds had been invested in government securities and corporate stocks and bonds. However, the rapid increase in the assets of pension funds and the desire to diversify have resulted in fund managers considering real estate loans as an additional source for investment.

CHAPTER 3 QUIZ

1. Short-term loans are preferred by:
 - A. Savings and loan institutions
 - B. Commercial banks
 - C. Insurance companies
 - D. Pension plans
2. Mortgage bankers would likely:
 - A. Use their own funds to make loans
 - B. Sell loans to investors
 - C. Service the loans they have sold
 - D. All of the above
3. Savings and loan institutions get most of their funds for real estate loans from:
 - A. Borrowing from the Federal Reserve
 - B. Stockholder equity
 - C. The sale of bonds
 - D. Individual savings
4. All of the following are Institutional lenders **except**:
 - A. Mortgage company
 - B. Commercial bank
 - C. Savings bank
 - D. Life insurance company
5. Which lender typically specializes in construction loans?
 - A. Life insurance company
 - B. Mortgage company
 - C. Savings bank
 - D. Commercial bank
6. A homeowner would least likely obtain a small equity loan from an:
 - A. Insurance company
 - B. Small loan company
 - C. Credit union
 - D. Commercial bank

7. Which class of lenders experienced the greatest "crisis" in the 1980s?
 - A. Commercial banks
 - B. Mutual savings banks
 - C. Life insurance companies
 - D. Savings and Loan associations
8. Insuring the deposits of commercial banks and savings banks is the
 - A. Office of Thrift Supervision.
 - B. Savings Association Fund.
 - C. Federal Home loan Mortgage Corporation.
 - D. Federal Deposit Insurance Corporation.
9. Which Institutional lender favors very large commercial property loans?
 - A. Commercial banks
 - B. Credit unions
 - C. Life insurance companies
 - D. Savings & Loans
10. The bulk of funds held by commercial banks are in the form of
 - A. Certificates of deposit (CDs).
 - B. Cash.
 - C. Demand deposits.
 - D. Securities.

*Chapter 3 Answers: 1-B, 2-D, 3-D, 4-A, 5-D, 6-A, 7-D, 8-D, 9-C,
10-C*

CHAPTER 4: NONINSTITUTIONAL LENDERS



PREVIEW

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

In this chapter you will study non-institutional lenders - real estate lenders whose activities are not as strictly regulated as institutional lenders. ***Non-institutional lenders***, also called ***non-fiduciary financing*** include private parties, mortgage companies, syndicates, real estate investment trusts, pension and trust funds, and credit unions.

SEMIFIDUCIARY AND NONFIDUCIARY LENDERS

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

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

fiduciary relationship. The distinction is quite fine, but it allows the semi-fiduciaries to take more risks than the primary.

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

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

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

PRIVATE LENDERS

Although the term private lenders in its broadest sense refer to virtually all non-government lenders, for our purposes a private lender is a person who lends directly to another person. This narrow definition will help to distinguish a private lender from the other forms of non-institutional lenders discussed in this chapter.

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

Unlike institutional lenders, private individuals have fewer laws and regulations that restrict their lending activities. However, individuals can be subject to the usury statutes that dictate the maximum interest rate that may be legally charged. Exemptions from the usury law are discussed later in this chapter.

TYPES OF PRIVATE LENDERS

SELLERS AS PRIVATE LENDERS

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

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

☞ A large number of private party loans are seller carrybacks.

PRIVATE MORTGAGE INSURERS (PMIS)

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

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

- ♦ **Purpose** - The bulk of the PMI business is the insurance of lenders against loss due to default on home mortgages. Most companies also insure lenders and investors against losses from commercial loans and leases, obligations of municipalities, and mobile home loans, and provide some casualty insurance. Increasingly, they insure the cash flow on mortgage-backed securities. The securities are backed by conventional loans, and most are linked to tax-subsidized revenue bonds issued by states and municipalities.
- ♦ **Mechanism** - PMI's deal only with lenders approved by them. Insurance is usually written for home mortgages with loan-to-value ratios above 80 percent. The PMI covers 20 to 25 percent of lender losses on such loans. Even after the lender has approved a loan, the PMI may approve or reject the lender's decision or may make conditions to be met for the loan to be approved.

CHARACTERISTICS OF PRIVATE LENDERS

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

- ♦ Most loans are on single-family dwellings because this type of property is most familiar to the typical private investor, and also because the size of the loan is relatively modest.
- ♦ The vast majority of loans by private individuals are made within the geographic areas most familiar to the lender.
- ♦ Private lenders are for the most part less formal, and therefore make highly subjective loan decisions, especially when making a loan directly to a borrower. On the other hand, mortgage brokers who represent private lenders are usually very sophisticated.
- ♦ High interest rates are normally charged, due to the high risks involved. However, exceptions exist in seller carryback transactions where a relatively low rate may be acceptable due to offsetting benefits. To compensate for, say, a 7 percent rate, a seller might either increase the price of the property or be willing to settle for the lower rate when the rates quoted on new first loans are so high that buyers are unwilling to pay high rates on the junior loan.
- ♦ Most private lenders operate in the second trust deed market. As pointed out previously, this is often created by the dictates of the marketplace, when a seller carries back a second deed of trust in order to close the transaction. *Frequently these*

second loans are thereafter sold to investors, usually at a discount, when the seller needs cash.

- ♦ Private lenders rarely make prime loans and almost never get involved in construction financing. (Prime loans are those that involve the least risk to lenders and are usually first liens.)
- ♦ The term of a private loan is usually short and often calls for a balloon payment. Six months to five years are the most common maturities.
- ♦ Monthly collections are frequently performed through a mortgage company or financial institution, though individual lenders may in some cases collect themselves. The setup and collection fees charged by commercial and savings banks are relatively small, since these institutions are interested in obtaining the customer's account. Some offer free collection service when the customer maintains a minimum balance in a savings or checking account.

USURY LAW

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

- ♦ **Maximum Rate** - In California the maximum rate for loans secured by real property is the greater of **10 percent or 5 percent above the Federal Reserve Bank discount rate**, unless the lender is exempt from the law.
- ♦ **Exemptions** - California regulations exempt from the usury law institutional lenders such as banks, thrift institutions, and life insurance companies. Also exempt are non-institutional lenders including *mortgage companies, credit unions, personal property brokers, owners who carry back paper when they sell*, and any transaction that uses a real estate broker. However, direct private lenders are not exempt. For example, real estate loans from regulated Institutional lenders can be at any rate, while an actual direct hard money real estate loan (not a seller carryback loan) from a private lender is not exempt, unless a real estate licensee is handling the transaction.

MORTGAGE COMPANIES

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

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

TYPES OF MORTGAGE COMPANIES

- ♦ **Investment Bankers** - Investment bankers make a market for both new and seasoned mortgage-backed securities. These firms, called *securities dealers*, buy and sell securities from lenders and investors. Mortgage bankers, savings banks, pension funds, insurance companies, and mutual funds generally conduct their secondary market transactions with investment bankers.
- ♦ **Mortgage Loan Brokers** are in the business of locating borrowers and lenders, and arranging loans between them. The loan broker takes no risk of loss. Another distinction between a *mortgage banker* and a *mortgage (or loan) broker* is that mortgage bankers service the loans of the lenders they represent, but loan brokers usually do not.
- ♦ **Mortgage Bankers** differ from mortgage brokers in that the former generally are not third parties to a loan, but personally fund the loans.

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

Many of the loans made by mortgage bankers are made for particular investors such as other lenders and pension plans. They will make the loans to meet the lending criteria desired by these particular investors. Much of their activities deal with out-of-state lenders and investors who desire to make long-

term loans secured by California real estate. Because of the size of our real estate market, California mortgage bankers can assemble packages of trust deeds of significant value.

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

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

CHARACTERISTICS OF MORTGAGE COMPANIES

- ♦ Type of institution - Brokerage.
- ♦ Mortgage companies do not take deposits, but finance their operations through short-term bank loans, their own capital, and fees from sales and servicing. They routinely sell nearly all the loans they originate, and are minor holders of mortgage debt.
- ♦ In California, mortgage companies are licensed by the **Department of Corporations**, and they are subject to lending and other general business regulations.
- ♦ Mortgage companies may also engage in a number of related real estate activities. These include brokerage, development, construction, and property management. This is especially true when activity in the mortgage market slows down.

SYNDICATION

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

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

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

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

In California, an "articles of organization" form must be filed with the Secretary of State to establish an LLC. The LLC format may incur higher fees and taxes than general or limited partnerships.

REAL ESTATE INVESTMENT TRUSTS

REAL ESTATE INVESTMENT TRUSTS (REITs) are trusts, owned by shareholders who can exchange their shares on the open market. REITs provide a means by which relatively small investors can participate in large-scale real estate investments.

REIT is a creature of the federal tax law. It was created in 1960 with the goal of encouraging small investors to pool their resources with others in

order to raise venture capital for real estate transactions. It has been called the "**mutual fund**" of the real estate business. Just as mutual funds invest in a diversified portfolio of corporate stocks and bonds, REITs invest in a diversified portfolio of real estate and mortgage investments, with a large number of investors who combine or pool their funds.

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

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

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

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

MORTGAGE POOL

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

CREDIT UNION

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

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

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

TYPES OF LOANS

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

SERVICING LOANS

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

Servicing loans means doing the accounting necessary for a loan. The one-quarter percent to one-half percent service fee can be a significant

profit center for the mortgage banker when thousands of loans are serviced.

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

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

SPECULATING

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

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

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

MORTGAGE WAREHOUSING

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

SCOPE OF MORTGAGE BANKERS

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

PORTFOLIO LOANS

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

CONFORMING LOANS

CONFORMING LOANS are loans that meet the purchase requirements of FNMA and FHLMC.

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

The U.S. Congress sets the maximum loan amount on conventional loans purchased by Freddie Mac and Fannie Mae.

☞ *The 2018 maximum for single-family FNMA loans will be \$453,100, an increase from \$424,100 in 2017.*

☞ *Loans that meet these limits are called **conforming loans**. Interest rates for conforming loans are often lower than rates for nonconforming loans.*

NONCONFORMING LOANS

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

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

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

MULTIPLE LENDERS

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

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

Another multiple-lender loan is a **PIGGYBACK LOAN**, where a single loan is divided into parts and the parts have varying degrees of risk.

As an example, assume a million dollar loan is sought on a project valued at \$1.3 million. One lender might agree to take \$700,000 of the loan as the bottom portion at 5-1/2 percent interest. A second lender might agree to take the top portion of the loan (\$300,000) at 8-1/2 percent interest. It is like a first and second trust deed written as a single loan. The second lender is subordinated to the first lender.

CHAPTER 4 QUIZ

1. Mortgage companies:
 - A. Prefer loans saleable in the secondary money market
 - B. Serve as temporary lenders
 - C. Are representatives for sources of money other than their own, yet sometimes lend funds of their own
 - D. All of the above
2. Mortgage companies arrange and supervise:
 - A. Loans for construction
 - B. Take-out (permanent) loans
 - C. Neither A nor B
 - D. Both A and B
3. In California, Mortgage companies are licensed by:
 - A. Department of Real Estate
 - B. Department of Insurance
 - C. Department of Corporations
 - D. Department of Consumer Affairs
4. When a mortgage banker establishes a line of credit with a commercial bank, the bank is acting as the mortgage banker's
 - A. investor.
 - B. correspondent.
 - C. warehouse for funds.
 - D. mortgage broker.
5. Real estate investment trusts are all of the following, except
 - A. corporations.
 - B. partnerships.
 - C. investment conduits.
 - D. owned by 100 or more investors.
6. The success of a mortgage broker depends upon all of the following, **except**
 - A. underwriting ability.
 - B. the number of defaulted loans.

- C. continuing relationship with investors.
 - D. continuing supervision of the loan.
7. Where applicable, the California law sets the usury maximum for loans secured by real property at:
- A. 10 percent
 - B. the discount rate charged by the Fed.
 - C. 5 points above the prime rate.
 - D. 10 percent, or 5 points above the current Fed discount rate, whichever is higher.
8. Exempt from California's usury law are, **except**:
- A. Institutional lenders
 - B. Private mortgage companies and credit unions
 - C. Private lenders with hard money loans
 - D. Real estate brokers and seller's carry back
9. The most popular organizational form of real estate syndication in California is the
- A. General partnership.
 - B. Corporation.
 - C. Limited partnership.
 - D. Real estate investment trust.
10. An organized group of people who agree to save their money and to make loans to one another is called a
- A. Syndication.
 - B. Credit union.
 - C. Pension fund.
 - D. Trust fund.

*Chapter 4 Answers: 1-D, 2-C, 3-C, 4-C, 5-A, 6-D, 7-D, 8-C, 9-C,
10-B*

CHAPTER 5: GOVERNMENT PARTICIPATION & BACKED LOANS



PREVIEW

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

THE FEDERAL RESERVE SYSTEM

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

PURPOSE

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

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

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

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

Figure 5-1: Federal Reserve Banks

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

BOARD OF DIRECTORS

The Federal Reserve Banks are not under the control of any government agency, but each Reserve Bank is under a board of directors, composed of nine members who represent business, the banking industry, and the general public in their Federal Reserve district. The directors are classified as A-, B- or C-class directors. Class A can come from the banking community of the district, class B can represent the borrowers of the district, and class C will represent the general public. Class B and class C directors cannot be connected to the banking industry in any way, including the owning of bank stocks.

The members of the board are primarily chosen by the banking community in the district. Class A and class B directors are elected by the

member banks, and the selection process sees that all sizes of banks are represented. Class C members are selected by the board of governors of the Federal Reserve.

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

BOARD OF GOVERNORS

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

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

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

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

MONEY SUPPLY

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

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

MEMBER BANKS

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

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

OPEN MARKET COMMITTEE

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

The committee members meet on a regular basis, usually the third Tuesday of the month in an unannounced location, to establish what action they should take to carry out the fiscal policy of the board. The decision they reach is not announced to the general public, but the decisions of the open market committee are published on a delayed basis in the *Federal Reserve Bulletin* to hinder speculation on government

securities and the U.S. dollar. The decision is carried out through a small staff that operates within the Federal Reserve Bank in New York. If the decision of the committee is to increase the supply of money, a member of the staff contacts a dealer who is licensed to deal in government securities and the dealer is given a check, drawn on the U.S. Treasury, to buy government securities. The check is then deposited into a member bank, thus increasing the supply of money available to the banking system in general. If the decision is to reduce the money supply, the committee makes recommendations to the board of governors to increase the reserve requirements or take any other action they may deem necessary.

MEASUREMENT OF THE MONEY SUPPLY

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

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

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

HOW DOES THE FED CONTROL THE SUPPLY OF MONEY?

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

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

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

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

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

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

It's not surprising that some experts refer to the Fed as the "**Banker's Bank**"!

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

There is a good example of how the use of increasing the reserve requirements and an increase in the discount rate can affect the economy. In the fall of 1979, the economy was in runaway inflation.

Inflation was at an annual rate of 13 to 14 percent and the Fed felt that it had to do something quickly. It raised the discount rate a full 1 percent, thus causing the interest rate to shoot up and cut the amount of money available. The real estate industry saw the interest rate on single-family loans go to 13 to 13.5 percent, if you could find a lender with funds to loan.

EFFECTS OF MONEY SUPPLY MANAGEMENT

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

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

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

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

EASY MONEY or LOOSE MONEY is the opposite of tight money. The Fed's easy-money policy is to reduce the reserve requirements and lower the discount rate. This is usually implemented in a time of recession. The Fed uses this policy to stimulate the economy. It increases the supply of money, making it easier for businesses and individuals to get credit. As credit becomes available, companies can expand, hire more people, and increase salaries. As these monies go into the banks and thrift

institutions, it tends to make more money available, and thus the cycle begins again.

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

THE TREASURY DEPARTMENT

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

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

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

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

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

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

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

Its purposes are enumerated as follows:

- ♦ To establish, under the Department of the Treasury, the Office of Thrift Supervision (OTS) to manage this nation's savings and loan institutions;
- ♦ To establish a new corporation, to be known as the Resolution Trust Corporation (RTC), to contain, manage and resolve failed savings associations; (This corporation completed its task and was dissolved 1995.)
- ♦ To promote the independence of the Federal Deposit Insurance Corporation from the institutions holding the deposits it insures by providing an independent board of directors, adequate funding and appropriate powers;
- ♦ To promote, through regulatory reform, a safe and stable system of affordable housing finance;
- ♦ Sets procedures for loans in federally related transactions by strengthening capital, accounting and other supervisory standards;
- ♦ To curtail investments and other activities of savings associations that pose unacceptable risks to the federal deposit insurance funds;
- ♦ To put the federal deposit insurance funds on a sound financial footing;

- ♦ To provide funds from public and private sources to deal expeditiously with failed depository institutions;
- ♦ To strengthen the enforcement powers of the federal regulators of depository institutions; and
- ♦ To strengthen the civil sanctions and criminal penalties for defrauding or otherwise damaging depository institutions and their depositors.

FIRREA governs all federally related transactions. A **FEDERALLY RELATED TRANSACTION** is any transaction in which the federal government is involved. Any real estate transaction, or any loan in which there is federal involvement of any kind, is affected.

☞ *For more information on FIRREA, visit: [http://fear.org/1/federal forfeiture Procedures/18 U.S.C](http://fear.org/1/federal_forfeiture_Procedures/18_U.S.C).*

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

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

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

The FDIC is appointed receiver or conservator for the purpose of reorganization or liquidation of failed banks and savings associations. If a bank or savings institution fails, the FDIC can take any appropriate action to put the insured deposit institution in a sound and solvent position. T

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

☞ *Federal Deposit Insurance Corporation (FDIC) insures individual deposits up to \$250,000.*

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

FEDERAL HOME LOAN BANK BOARD

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

☞ FHLBB has been eliminated by FIRREA.

SMALL BUSINESS ADMINISTRATION

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

GOVERNMENT SERVICES AGENCY

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

THE FEDERAL LAND BANK AND THE FARMERS HOME ADMINISTRATION

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

FEDERAL MORTGAGE FINANCE SYSTEM

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

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

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA)

The Government National Mortgage Association (GNMA), commonly called "Ginnie Mae" (GNMA) is a quasi-government agency, which participates directly in mortgage finance, as a guarantor of pool securities, and through management of loans under special subsidy program and the tandem plan.

Its basic mission was to create and operate a mortgage-backed security program for FHA and DVA mortgages.

PASS-THROUGH SECURITY

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

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

With the certificate in hand, the lender is able to sell the mortgages to an investor. When the investor buys the mortgages, it receives the certificate. Typically, the securities are purchased by securities dealers who trade in Ginnie Mae securities. They in turn sell the securities to other investors such as insurance companies, pension funds, and other lenders who need mortgages, and individuals. The securities can be broken down into smaller denominations to satisfy the demands of the

various investors (the smallest denomination is \$25,000). The securities are traded on Wall Street just like stocks and bonds. There is an active market for the securities, which makes them a liquid investment.

☞ *For more information on Ginnie Mae visit: www.ginnemae.gov*

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA) / FANNIE MAE

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

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

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

☞ *FNMA is a federally sponsored secondary mortgage market agency.*

CHARACTERISTICS OF FANNIE MAE

- ♦ **Secondary Market Role** - FNMA is the largest and oldest major secondary money market for mortgage notes.
- ♦ **Loans Purchased** - FNMA purchases existing FHA, DVA, and conventional loans, and makes advance commitments to purchase future loans.
- ♦ **Sale of Loans** - FNMA auctions loan portfolios (groups of loans) to investment groups and individuals.

- ♦ **Organization** - Stockholder owned, FNMA is headed by a 15-member board of directors, five appointed by the President of the United States and 10 elected by stockholders. It is subject to policy supervision by the Department of Housing and Urban Development and regulation in credit markets by the Treasury. FNMA is authorized to borrow directly from the Treasury, but the authority has never been used.
- ♦ **Mechanism** - FNMA raises capital through issuance of stock, both common and preferred; sales of debentures and notes, which are classified under "federal agency debt" in credit markets, even though they are not debts of the government; fees from commitments and guarantees; and sales of mortgages and securities backed by pools of mortgages.
- ♦ The corporation buys mortgages, including first and second liens, fixed- and adjustable-rate loans, graduated payment and other types of loans. A federally mandated ceiling for home loans is adjusted annually in accordance with a house price index.
- ♦ **Commitment System** - Lenders wishing to sell mortgages to FNMA may do so "over the counter" at posted prices with mandatory delivery of the mortgages, or may obtain a "standby" or "convertible" commitment from FNMA to take the mortgages within a specified period. Since 1981, most commitments have been limited to one or two months. Commitments may be obtained at posted prices or by bidding for them at biweekly auctions.

☞ *For more information on Fannie Mae visit www.fanniemae.com*

FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC) / FREDDIE MAC

The **Federal Home Loan Mortgage Corporation (FHLMC)** also known as **Freddie Mac** was created by the Emergency Home Finance Act of 1970. FHLMC is owned by the 12 Federal Home Loan Banks to manage their own secondary mortgage market..

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

Because Ginnie Mae included only FHA and DVA mortgages in its securities, there was a great need to develop a mortgage-backed security for *conventional loans*. In 1971, the Federal Home Loan Mortgage

Corporation, introduced the first security backed by conventional loans. Freddie Mac is a subsidiary of the Office of Thrift Supervision (OTS), which supervises the federally chartered thrifts. As a government-chartered, stockholder-owned corporation, FHLMC buys mortgages and sells them in the secondary market.

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

CHARACTERISTICS OF FREDDIE MAC

- ♦ **Type Of Institution** - Originally Federally sponsored secondary mortgage market agency.
- ♦ **Organization** - FHLMC is owned by the twelve Federal Home Loan Banks which are in turn owned by the savings and loan associations making up the system's membership. FHLMC has a three-member board of directors who are also the three members of the Federal Home Loan Bank Board appointed by the President. FHLMC may borrow from the Treasury indirectly through the consolidated borrowings of the FHLB system. FHLMC is a profit-making enterprise which is tax exempt because it is owned by a non-profit government enterprise (the FHLB system) and distributes all its dividends to the system.
- ♦ **Functions** - FHLMC's purpose is to increase the availability of credit in the secondary mortgage market by:
 - Buying real estate loans and reselling them in mortgage pools.
 - Financing its loan purchases through the sale of stocks to the Federal Home Loan Banks and through the sale of bonds and notes on the open market.
- ♦ **Mechanism** - In late 1982, FHLMC was given permission to issue preferred stock in addition to the non-voting common stock held by the banks. Aside from issuing newly authorized preferred stock, FHLMC raises funds for its operations by issuance of bonds and notes through the FHLB consolidated debentures system (limited); by sales of securities backed by

pools of mortgages; and through imposition of commitment and servicing fees on users of the corporation.

- ♦ **Market Role** - Although FHLMC initially built up a portfolio of FHA/DVA mortgages, it now deals almost entirely in conventional mortgages, including standard, graduated, adjustable, and other forms. A federally mandated ceiling for home loans is adjusted annually in accordance with a price index. Loans within these ceiling limitations are termed "conforming" loans. FHLMC is a major source of multifamily rental project mortgage money. FHLMC packages substantially all of the mortgages it purchases into pools and issues securities (participation certificates, or PCs) against them. FHLMC also has issued certificates which perform more like bonds than "passthroughs" (guaranteed mortgage certificates, or GMCs). FHLMC is the major issuer of conventional mortgage-backed securities.
- ♦ **Authorization** - The FHLMC may buy and sell conventional, shared equity, FHA, and DVA loans, thereby encouraging the savings and loan associations to make more FHA and DVA loans.
- ♦ **Benefits** - Encourages growth in the secondary mortgage market by allowing the lenders to sell real estate loans (liquidity) and by providing the investors with these loans without the need for complicated loan origination or service Systems, thereby giving the borrowers greater choice of lenders.

☞ *FNMA and FHLMC are private corporations now; their stock is listed on the New York Stock Exchange.*

As a result of the 2008 financial meltdown, Congress changed the framework for regulation of Fannie Mae and Freddie Mac by placing them in conservatorship with a new federal agency called the **Federal Housing Finance Agency (FHFA)**. This agency replaced HUD as regulator of FNMA, FHLMC, and the federal home loan bank system.

☞ *For more information on Freddie Mac visit at www.freddiemac.com*

GOVERNMENT BACKED LOANS (FHA, DVA, CALVET)

There are two major categories of loans. One is **GOVERNMENT-BACKED LOANS**, where federal and state agencies participate directly in residential loan financing, which include the Federal Housing Administration, the U.S. Department of Veterans Affairs, the California Department of Veterans Affairs, and **NON-GOVERNMENT-BACKED LOANS**, which are a various city-backed subsidized home loan programs.

In this section, we discuss what these programs do and their advantages and disadvantages.

FEDERAL HOUSING ADMINISTRATION

The Federal Housing Administration (FHA) was created by the passage of the National Housing Act of 1934. With the passage of the Department of Housing and Urban Development Act, all of the functions, powers, and duties of FHA were transferred to the control of the secretary of HUD.

The purpose of FHA is threefold:

- (1) upgrade the nation's housing standards;
- (2) promote wider home ownership; and
- (3) provide continuing and sound methods of financing home mortgages.

The following are a number of important secondary results:

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

FHA is **NOT** a lender. FHA **issues** an insurance policy on loans that meet the underwriting requirements of the National Housing Act. This insurance policy ensures the lender that if the loan goes into default, FHA will make

the loan good by taking the property and paying off the lender either in cash or with debentures guaranteed by the United States government.

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

HUD-FHA is headquartered in Washington, DC. There are ten regions and these regions have further been divided with the establishment of area offices to make FHA more responsive local needs.

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

FHA LOAN FEATURES

In addition to the introduction of mortgage insurance, FHA insurance has a number of features that distinguish it from a conventional loan. Some of the significant features are:

- ♦ **Lower Down Payments** - The advent of the higher loan-to-value ratio meant a lower down payment to the homebuyer and thus made housing available to more of the general public. Today, only **3.5%** of down payment is needed. and most of your closing costs and fees can be included in the loan, available on 1-4 unit properties."
- ♦ **Lower Interest Rates** - In keeping with the investment policy that the lower the risk the lower the return, FHA loans usually have lower interest rates than a conventional loans protecting the lender.
- ♦ **Impound Accounts** - Prior to the FHA-insured loan, the person receiving the loan was responsible for seeing that all taxes were paid on time and that there was insurance on the property. As with most people, they did not make allowances for the once-a-year payments, and in many cases the property was lost due to a tax lien. Often the property was damaged by fire and the owner did not have insurance to cover the loss. FHA, with the advent of the escrow account, made sure that the lender was less likely to lose the property due to tax liens and made sure that there was insurance coverage on the property. This was also an advantage for the property owner in that he did not have to make a lump sum

payment for taxes and insurance, but would set aside one-twelfth of the cost each month.

- ♦ **Minimum Property Standards** - FHA was the first lender or insurer of mortgages to set minimum standards for the property. These standards have constantly been upgraded to make sure that the property securing the mortgage is safe, sanitary, and livable. The standards covered such things as the amount of insulation, arrangement of rooms, number of baths, and the type of wiring used in a house.

The lender is required to obtain an appraisal of the property from an FHA-approved appraiser. The appraiser will note any major health and safety deficiencies on the Uniform Residential Appraisal Report (URAR).

Some have referred to these standards as a "national housing code." The requirements of FHA were the same no matter where in the United States the property was located.

The FHA requires that existing property must have no evidence of termite infestation, and certification must be obtained from a recognized termite inspection company. Minor cosmetic repairs are not required to be reported by FHA appraisers, but major repairs must be reported.

- ♦ **Prepayment Penalties** - No prepayment penalties are allowed: Some conventional loans have substantial prepayment penalties for the first few years of the mortgage term. An FHA loan may be paid off in full at any time with no additional charges. A lender is allowed to require that any such payment be made on a regular installment due date.
- ♦ **No Secondary Financing Is Allowed For The Down Payment** - The FHA minimum down payment for a loan must be paid by the borrower in cash. The borrower is not allowed to resort to secondary financing from the seller or from any lender to make up any part of the down payment.
- ♦ **FHA Mortgage Insurance Premium (MIP)** - FHA mortgage insurance (PMI) is "required" for the loan regardless of the amount of the down payment. In contrast, conventional loans usually do not require mortgage insurance unless the loan-to-value ratio exceeds 80%.

- ♦ **Loan Term & Loan Point** -The typical life of the mortgage loan is thirty-year term, but can be as short as fifteen years. They offer fully amortized, fixed as well as adjustable loans and home repair loans.
- ♦ **Upfront Discount Points** - A disadvantage is that the seller, as with a conventional loan may in some cases have to pay a discount or points to have a property financed through FHA.

Lender may only charge a 1% loan origination fee on an FHA loan, but is allowed to charge discount points.

Typically, discount points allow a lender to recover any interest loss up front. These points may be paid by either the buyer or another party. Although discount points may be paid by the buyer in an FHA transaction, they are almost always paid by the seller.

This money is usually expressed as a percentage called points. Each point is equal to one percent of the loan amount. These points may be paid by the seller. These discount points range from one to as many as eight. If a person wished to sell a house and the FHA loan was \$570,000, each point of discount that was charged by the lender cost the seller \$5700, or one percent of the loan amount.

- ♦ **Assumable** - FHA allows a person to assume an existing mortgage without the escalation or change of the interest rate. This escalation or change of interest for the assumption of a mortgage still exists today for some types of conventional mortgages. FHA felt that with America being a mobile society, the transfer of property should be made as easy as possible and one way was to allow those mortgages meeting the standards of FHA to be assumable.

☞ *FHA loan must be owner occupied.*

MORTGAGE INSURANCE PREMIUM

FHA mortgage insurance is "required" for the loan regardless of the amount of the down payment. In contrast, conventional loans usually do not require mortgage insurance unless the loan-to-value ratio exceeds 80%.

FHA **Mortgage Insurance Premium (MIP)** is a commitment to the lender that the loan will be repaid if the borrower cannot make the required monthly payments. The FHA secures funding for its loan

insurance program by imposing a mortgage insurance premium that must be paid by each borrower obtaining an FHA-insured loan.

FHA requires two kinds of mortgage insurance premiums: one is paid in full upfront, **Upfront Mortgage Insurance Premium (UFMIP)** – or, it can be financed into the mortgage – and the other is a monthly payment insurance (MMI).

The FHA requires that monthly payments include principal and interest, taxes, fire insurance and **Mutual Mortgage Insurance (MMI)**, often referred to as "PIT + MMI." The monthly amounts paid toward taxes, insurance, and MMI are deposited in an impound account, also called an escrow account.

UPFRONT MORTGAGE INSURANCE PREMIUM (UFMIP) —

Appropriately named, this is a one-time upfront monthly premium payment, which means borrowers will pay a premium of **1.75% of the home loan**, regardless of their credit score. Example: \$300,000 loan x 1.75% = \$5,250. This sum can be paid upfront at closing as part of the settlement charges or can be rolled into the mortgage.

MONTHLY MIP (CHARGED MONTHLY) — This is a monthly charge that will be figured into your mortgage payment. The amount of the mortgage insurance premium is a percentage of the loan amount, based on the borrower's loan-to-value (LTV) ratio, loan size, and length of loan:

Loan Term	Loan Amount	LTV Ratio	Annual Insurance Premium
Over 15 years	\$625,000 or less	95% or less	0.80%
Over 15 years	\$625,000 or less	Over 95%	0.85%
Over 15 years	Over \$625,000	95% or less	1%
Over 15 years	Over \$625,000	Over 95% or less	1.05%
Over 15 years	\$625,000 or less	90% or less	0.45%
15 years or less	\$625,000 or less	Over 90%	0.70%
15 years or less	Over \$625,000	90% or less	0.70%
15 years or less	Over \$625,000	Over 90%	0.95%

For example, the annual premium on a \$300,000 loan with term of 30 years and LTV less than 95 percent would be \$2,400: \$300,000 x 0.80% = \$2,400. To figure out the monthly payment, divide \$2,400 by 12 months = \$200. So, the monthly insurance premium would be \$200 per month.

FHA LOAN LIMITS (2017)

The Federal Housing Authority sets maximum mortgage limits for FHA loans that vary by state and county. In certain counties.

LOW COST AREA LIMITS (THE "FLOOR")

The following table shows the standard FHA loan limits for areas that are not considered high cost.

Loan Type	One Unit	Two Units	Three Units	Four Units
FHA Forward	\$294,515	\$377,075	\$455,800	\$566,425

HIGH-COST AREA LIMITS (THE "CEILING")

The following numbers apply to high-cost areas. Please note that high-cost areas vary from state to state, and not all states have high-cost areas. You can also view the entire list of high-cost area FHA loan limits

<https://www.hud.gov/sites/dfiles/Housing/documents/2018AREASATCEILING.pdf>

Loan Type	One Unit	Two Units	Three Units	Four Units
FHA Forward	\$679,650	\$870,225	\$1,051,875	\$1,307,175

FHA TITLES & SECTIONS

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

TITLE I - PROPERTY IMPROVEMENT LOANS

An FHA Title 1 loan is a fixed-rate loan used for home improvements, repairs and rehab. (Adjustable-rate loans aren't offered.) Loans under \$7,500 are usually unsecured; your signature will suffice. Larger loan amounts will require using your home as collateral. You get the loan from an FHA-approved lender.

The definition of FHA Title 1 loan "improvements" is fairly broad: The Department of Housing and Urban Development says the money can be used for anything that makes your home "basically more livable and useful."

That includes buying appliances, such as dishwashers, built-in ovens, refrigerators and freezers. Home improvements that aim to expand accessibility for disabled people are also allowed, as are energy-efficient upgrades such as solar energy systems.

☞ HUD says the money can be used for anything that makes your home 'basically more livable and useful.' That includes buying appliances.

TITLE II - MORTGAGE INSURANCE LOANS

Title II of the National Housing Act sets up a permanent program of mortgage insurance loans including the following types:

Section 203, 207, 213, 220, 221, 222, 223, 231, 232, 233, 234, 235, 236, etc, Title X, Title XI

The most commonly encountered are Sections 203(b), 203(k) and 245.

SECTION 203(B)

The FHA 203(b) loan insurance program is for people who want a single-family FHA insured mortgage loan. The FHA 203(b) "may be used to purchase or refinance a new or existing one-to-four family home in both urban and rural areas including manufactured homes on permanent foundations" according to FHA.gov.

For these FHA guaranteed loans, lenders offer loan terms at 15 or 30 years. The FHA does not set interest rates for these loans, instead they are negotiated between the borrower and lender.

When you compare the terms and conditions of some conventional mortgages to those offered under FHA 203(b), you'll learn a great deal. The 203(b) is often easier to qualify for thanks to more lenient credit requirements and the FHA's guarantee of the loan, protecting the lender from situations where the borrower may go into default or foreclosure.

Many types of FHA insured home loans available besides the 203(b), but it's the one many FHA loan applicants are thinking about when they explore their options for purchasing a new home. Ask about your FHA loan options and you'll soon get plenty of information you can use to start your house hunting journey.

SECTION 203(K)

An FHA 203(k) loan simplifies the home renovation process by allowing you to borrow money for your home purchase and home renovation costs

using only one loan. In other words, an FHA 203(k) loan allows you to finance both the purchase of a house, and the cost of turning that house into your dream home, through a single mortgage. FHA 203(k) loans are backed by the federal government, and are a great loan option for those who want to purchase a home and perform upgrades, repairs, remodel or customize to their needs and wants.

While the idea of purchasing a fixer-upper and transforming it into your dream home may seem great in theory, the reality can be harsh once the true cost of a home remodel start sinking in. Unfortunately, many homeowners give up on their dream of designing the perfect home, one renovation at a time, because they automatically assume the project will be unaffordable. That's where an FHA 203(k) mortgage loan comes in.

If you plan to purchase a fixer-upper or need to make improvements to your existing home, an FHA 203(k) loan may be the perfect rehab loan for you. By folding the construction costs into your home mortgage, an FHA 203(k) loan limits your loan closing costs with just one loan that provides you the necessary funds to buy a home and make the desired repairs or improvements on that home.

An FHA 203(k) loan simplifies the home renovation process. FHA 203(k) loans are backed by the federal government, and are typically given to buyers who want to purchase a home and perform upgrades, repairs, remodel or customize to their needs and wants. they would be able to through conventional financing programs.

ELIGIBILITY

Most lenders who use this mortgage insurance product make their requests through a provision known as "**direct endorsement**," which authorizes them to consider applications without submitting paperwork to HUD.

*☞ A lender who has FHA permission to carry out a loan from origination to closing is called a **direct endorsement lender**.*

SECTION 245 - GROWING EQUITY MORTGAGES (GEM)

Growing Equity Mortgages are available to anyone who anticipates their earnings to increase appreciably and intends to use the mortgaged property as their primary residence.

FHA Growing Equity Mortgages are home loans that are tailored for first time home buyers or young families. These likely homebuyers are often

not in a position that would warrant them being able meet the many upfront and monthly costs that are involved.

FHA's Section 245(a) enables those who currently have a limited income but expect their monthly earnings to increase, to purchase a home with the help of a Growing Equity Mortgage in which payments start small and increase gradually over time. As the mortgage payments grow the additional payment is applied toward the principal on the loan thus reducing the mortgage term. Growing Equity Mortgages also allow homeowners who are interested in further reducing the term of their mortgage to apply scheduled increases in their monthly payments to the outstanding principal balance.

Through this and other types of mortgage insurance programs, the lender helps low and moderate-income families purchase homes by keeping the initial costs down. By serving as an umbrella under which lenders have the confidence to extend loans to those who may not meet conventional loan requirements, FHA's mortgage insurance allows individuals to qualify who may have been previously denied for a home loan by conventional underwriting guidelines. It also protects lenders against loan default on mortgages for properties that include manufactured homes, single-family and multifamily properties, and some health-related facilities.

Through the Growing Equity Mortgage program first-time home buyers and others with limited incomes can start out with a low monthly mortgage payment that will increase gradually over time therefore allowing them to purchase a home sooner than they would be able to through conventional financing programs.

DEPARTMENT OF VETERANS AFFAIRS

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

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

PROCEDURE

The basic intention of the VA home loan program is to supply home financing to eligible veterans and to help veterans purchase properties with no down payment. The loan may be issued by qualified lenders.

These loans are administered by the U.S. Department of Veterans Affairs. A DVA appraiser estimates value and issues a "Certificate of Reasonable Value" (CRV). The loan is then made by an approved lender.

ADMINISTRATION OF DVA

The GI Bill of Rights is a bill provided many benefits to veterans, including provisions guaranteeing real estate loans to veterans. The loan Guarantee Division of the Department of Veterans Affairs is responsible for administering the program. Generally, the DVA operates like the FHA.

☞ One difference between FHA and DVA is that the DVA guarantees a loan, and while the FHA insures a loan, and while the FHA insures the whole loan, the DVA guarantees a portion of it.

FORECLOSURE

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

1. It can pay the lender the balance on the loan and take back the property.
2. It can give the lender the property and pay it the amount of the deficiency, up to the maximum amount of the guarantee.

With FHA loans, the lender is always paid off and the property is taken back by the FHA.

GENERAL INFORMATION ON DVA LOANS

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

No Down Payment

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

The DVA does not require a down payment. The veteran is allowed to borrow the full amount of the purchase price. What happens if the DVA appraises the property for less than the purchase price? At one time, the

DVA would not allow the veteran to pay more than its appraisal. This caused problems, since many veterans were willing and able to do so, and the policy prevented these veterans from purchasing a house of their choice. The regulation has since been eliminated. Now, the DVA will allow a veteran to pay more than the appraisal, but the loan amount cannot exceed the appraisal. The difference between the purchase price and the appraisal has to be in cash, and the money cannot be borrowed.

CERTIFICATE OF ELIGIBILITY

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

*The **CERTIFICATE OF ELIGIBILITY** indicates the amount of the veteran's entitlement.* The entitlement is the maximum number of dollars that the DVA will pay if the lender suffers a loss.

VA LOAN LIMITS AND ENTITLEMENTS/GUARANTEE

Entitlement plays a key part in determining how much you can borrow before a down payment enters the equation.

For the VA, entitlement refers to how much money it will **guarantee repayment** to lenders in the event that a borrower defaults. Often, the VA guaranty is 25 percent of the loan, which provides most of the country with a standard entitlement figure.

But the structure of the entitlement equation enables military borrowers to have more than one VA loan at a time or even qualify for a VA loan after foreclosure.

There are two types, or tiers, of entitlement. The first, basic entitlement is **\$36,000**. In most of the U.S., borrowers can receive a secondary entitlement of \$77,275. That's a **total entitlement of \$113,275** for borrowers in a bulk of the country.

Qualified borrowers with full entitlement (\$113,275) can borrow up to **\$453,100** on a VA loan without worrying about a down payment in most parts of the U.S. It is possible to borrow above the VA county loan limit, but then down payments become a factor.

Guaranty amounts for loans of \$417,000 or less are unaffected, and on loans for more than \$417,000, the VA will guaranty 25% (or \$36,000 x 4

= **\$144,000**) of the original loan amount up to maximum guaranty. Maximum guaranty amount varies depending on location of the property

Borrowers in high-cost counties could get a VA home loan for up to **\$729,750** and, for Alaska, Guam, Hawaii, and the U.S. Virgin Islands, the figure was as high as **\$1,094,625**. These figures are always changing adjusted annually.

☞ Consult ***www.fhaoutreach.com*** to calculate the maximum guaranty for a particular property

TYPE OF PROPERTY

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

OWNER OCCUPYING THE PROPERTY

The veteran must occupy the property. The DVA does not have a program for veterans who do not intend to occupy the property.

TAXES AND INSURANCE

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

REPAYMENT PENALTY

None.

SECONDARY FINANCING

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

Secondary financing can be approved on a case-by-case basis by the DVA regional office acceptable. Generally, it is desirable that the second carry

the same interest rate and terms as the first loan. The first and second loans added together cannot under any circumstances be more than the CRV. An example where a second can be used is as follows:

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

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

DISCOUNT POINTS

While no mortgage insurance is required, the VA charges a funding fee that is currently set at 2.15% on non-down payment loans. For second-time users with eligibility, the fee is 3.3%. With a down payment of 5%, the fee for both first- and second-time users is 1.5%. For a 10% down payment, the fee drops to 1.25%. The fee may be financed in the loan. These fees are waived for veterans receiving benefits for service-connected disabilities or surviving spouses of a veteran who died in service or from a service-connected disability.

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

ASSUMPTION AND RESALE TO ANOTHER VETERAN

One veteran may assume another veteran's loan by substituting eligibility.

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

The GI loan may be assumed by a **non-veteran** with USDVA approval. "**Subject to**" - Unless the veteran (seller) obtains a "release from liability" certificate from the DVA, the veteran remains liable. Even with USDVA approval of assumption, the veteran does not regain eligibility until the loan is fully paid off.

LOAN TERM

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

CLOSING COSTS

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

Current closing cost items include:

1. A maximum 1% loan origination fee,
2. Appraisal fees are set by Regional VA offices. The fee may not be more than is reasonable and customary for the area,
3. Credit report fees may not exceed the cost charged to the lender. Credit research fees of \$50.00 charged by Loan Prospector® are allowed,
4. The veteran may pay for hazard and flood insurance, if required,
5. The veteran may pay for title insurance,
6. The veteran must pay the VA funding fee,
7. The veteran may pay for recording fees, and
8. The veteran is responsible for prorated interest and property taxes.

CAL-VET LOANS

The U.S. Department of Veterans Affairs has for decades guaranteed mortgage loans on behalf of eligible military veterans, and California offers a mortgage loan program of its own to assist eligible military veterans. California Department of Veterans Affairs CalVet mortgage loans and VA mortgage loans are similar in many respects, and both aim to help military veterans purchase homes. However, there are several differences.

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

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

CALVET ELIGIBILITY REQUIREMENTS

Only military veterans and current active duty military personnel living in California are eligible for a CalVet mortgage loan. VA-guaranteed mortgage loans are available nationwide to all eligible military veterans, including in California. Eligibility requirements for CalVet home loans are a little broader than you'll find when looking at a VA mortgage loan. Changes to California's Military & Veterans Code mean that most

veterans, excepting those with less-than-honorable or punitive discharges, are eligible for CalVet home loans.

DIFFERENCE BETWEEN CALVET VERSUS VA MORTGAGES

The biggest difference between CalVet and VA mortgages is that CalVet mortgages is holding of title. Basically, CalVet purchases a qualified military veteran's desired property and then sells it to him using a contract of sale.

The CalVet program actually holds **legal title** to the home bought with a CalVet mortgage, while the military veteran holds **equitable title** — the right to obtain full ownership of the home. Military veterans using CalVet mortgages always receive immediate full legal title to and ownership of their properties.

BENEFITS OF CALVET MORTGAGES

Equitable title in a CalVet-procured home still gives you many ownership rights, including to property tax and mortgage interest deductions. Because CalVet holds legal title to the home you bought using its mortgage, it can obtain an inexpensive group rate for the homeowners insurance you'll carry. CalVet allows veterans to finance the funding fee charged for their loans and also offers 100 percent, no-down-payment financing. CalVet's maximum loan amount of \$589,785 covers Alameda and San Francisco counties. This is lower than VA financing available, which maxes out at \$636,150.

CALVET AFFECT ON VA ELIGIBILITY

In some cases when you use a CalVet mortgage, your VA loan entitlement is affected. To fund some of its loans, CalVet goes to the VA and obtains a guarantee on them. If you're buying a home using a CalVet loan and the guarantee actually comes from the VA, it may reduce your loan entitlement from the VA. Your CalVet and VA loan eligibility are restored once you've paid off or refinanced your CalVet mortgage into a loan from a traditional lender.

ELIGIBILITY

Any veteran who lives in or moves to California may qualify and both wartime and peacetime veterans are eligible.

CalVet uses the VA underwriting and packaging requirements and the veteran needs to provide a Certificate of Release or Discharge from Active Duty Form DD214.

California veterans must apply for a Cal-Vet loan within 25 years following release from active duty. Those who were wounded, disabled or were prisoners of war have 30 years.

LOAN ORIGATION FEE

The maximum allowable origination fee that can be charged is 1%. No monthly mortgage insurance premiums.

ADMINISTRATION

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

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

ADVANTAGES AND DISADVANTAGES OF CAL-VET LOANS

The main advantages of Cal-Vet loans are its relatively low interest rate; inexpensive life, fire, and disaster (flood, earthquake) insurance; and low closing costs.

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

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

Figure 5-2: Comparison of Government-Backed Loans (as of January 2016).

FEATURE	FHA	DVA	CAL-VET
Purpose of loan	1-4 units	1-4 units	Single dwellings, condominiums
Eligibility	U.S. resident	U.S. veteran	Qualified veteran

REAL ESTATE FINANCE

Expiration of eligibility	Indefinite	Indefinite	Must apply within 30 years from date of discharge
Maximum purchase price	None	None	None
Maximum loan	Varies by counties \$679,650	by None by DVA; lenders limit loan amount \$636,150	\$589,785 for San Francisco County
Down Payment	Minimum 3.5 percent	3.5 None, but limited to CRV	2 percent to 3 percent
Maximum term	30 years	30 years	30 years
Secondary financing	Allowed with limitations	Allowed with limitations	Allowed with limitations
Interest rate	Fixed	Fixed	Variable rate
Prepayment penalty	None	None	None

 For more information on Cal-Vets, visit www.cdva.ca.gov

STATE AND LOCAL REGULATIONS

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

STATE FINANCIAL AGENCIES

These enforce and are regulated by the California law regarding licensed savings and loan associations, banks, insurance companies, credit unions, and mortgage companies. They can have far-reaching effects upon the mortgage market.

- ♦ Department of Banking
- ♦ Department of Insurance
- ♦ Department of Corporations
- ♦ Department of Real Estate
- ♦ California Housing and Financing Agency

LOCAL GOVERNMENT AGENCIES

Many local agencies and commissions can affect the mortgage market in terms of supply and demand of money and property in their immediate area. These include:

ZONING COMMISSION

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

CALIFORNIA HOMESTEAD LAW

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

PROTECTION

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

Eligible Property - Any residence may be homesteaded, but vacant land is not eligible. Single-family residence, including a mobile home. Multiple units, if one unit is owner-occupied

Claims Protected Against - Homesteaded property is protected against judgments recorded *after* the recording of a declaration of homestead, for: damages; medical bills; business debts

Claims Not Affected - homesteading does not protect against secured liens of taxes, mortgage, trust deed, or mechanics liens, or against an unsecured lien recorded prior to the recording of the homestead declaration.

Amount of Protection - The home is protected against seizure and sale as long as the owner's equity does not exceed the allowed exemption of:

- \$75,000 for any person, except
- \$100,000 for a member of a "family unit"
- \$175,000 if the homestead declarant or the declarant's spouse is 65 years of age or older, or physically or mentally disabled and thus unable to work, and this is so stated in the declaration, or if the declarant is 55 years of age or older single, have a low income *and* creditors seek to force the sale of your home.

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

CLAIMING THE EXEMPTION

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

Effects - A recorded declaration of homestead:

- Will be valid against eligible debts if recorded any time prior to the recording of the unsecured creditor's judgment.
- May be declared by either spouse on community, joint tenancy, or tenancy in common property, but not on separate property of the other spouse in which declarant has no ownership interest.
- Is not an encumbrance.

Required Information - Declarant must state the following. Any false statement invalidates a homestead.

- Claimant is "head of family," if such is the fact
- If married, name of spouse
- Whether 65 years of age (to obtain higher exemption amount)
- Resides on premises claimed as a homestead
- Description of premises

Termination - A homestead is ended by three methods only:

- Recording notice of "Abandonment of Homestead"
- Sale of homestead property
- Recording of a subsequent "Declaration of Homestead"

FORCED SALE OF A HOMESTEAD

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

Priority of Distribution - Money realized from the forced sale is allocated to outstanding claims in the following order:

1. Cost of sale
2. Taxes and assessments
3. Secured liens (mortgage, trust deed, mechanics liens, etc.)

4. Declarant's exemption
5. Unsecured creditors claim
6. Balance to declarant (if any)

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

DECISION TO HOMESTEAD

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

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

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

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

INTERNET WEB LINKS

www.fanniemae.com	Supplier of conventional home mortgages funds in terms of assets, and issues debt.
www.freddiemac.com	Stockholder-owned corporation chartered by Congress in 1970 to create a continuous flow of funds to mortgage lenders.
www.ginnemae.gov	About Ginnie Mae. What's New. ARMs. Guides. Resources
www.ofheo.gov	Office Of Federal Housing Enterprise Oversight (OFHEO). Their primary mission is ensuring the capital adequacy and financial safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

REAL ESTATE FINANCE

www.va.gov	Provides information on VA programs, veteran's benefits, VA facilities worldwide, and VA medical automation software.
www.hud.gov	U.S. Department of Housing and Urban Development (HUD)
www.fhatoday.com	FHA mortgage center offers purchase and refinance loans to home buyers nationwide. FHA mortgage lenders offers purchase and streamline refinance mortgages to home buyers nationwide.
www.cdva.ca.gov	Cal-Vet Loans

CHAPTER 5 QUIZ

1. The FHA title that is used to purchase homes is:
 - A. Title I
 - B. Title II
 - C. Title III
 - D. Title IV

2. FHA-insured loans insure lenders against:
 - A. Decline in real estate values.
 - B. Loss due to foreclosure.
 - C. Loss due to borrowers losing their jobs.
 - D. Late payments by borrowers.

3. All of the following regarding the Federal Reserve System are true, except:
 - A. The board of governors consists of seven members
 - B. Each governor is appointed for a 14 year term
 - C. It was created by an act of Congress
 - D. There are seven regional banks

4. The FHA has established certain MPRs that must exist before they will insure a loan. MPR is an abbreviation for:
 - A. Maximum probability ratio
 - B. Mortgage protection rate
 - C. Minimum property requirements
 - D. Market price rating

5. A program where GNMA and FNMA for buying loans at par, which is less than market value, is known as:
 - A. A pass through
 - B. The Tandem plan
 - C. REMIC
 - D. Discounting

6. When the Federal Reserve Bank feels that there is an inflationary trend in the United States, it is likely to do which of the following:
 - A. Adjust the amount of reserves required for its member banks
 - B. Increase the discount rate
 - C. Enter into the government bond market in a selling capacity
 - D. All of the above

7. The term CRV refer to:
 - A. Certified regional valuations.
 - B. Certified Reasonable value.
 - C. A loan guaranteed by the Department of Veterans Affairs.
 - D. A real estate agent who specializes in GI loans.
8. The Federal Home Loan Bank:
 - A. Provides a secondary mortgage market for savings & loan.
 - B. Provides insurance to depositors in state and federal banks.
 - C. Insures commercial bank depositors against loss
 - D. All of the above
9. The Federal National Mortgage Association:
 - A. Is a stockholder-owned corporation
 - B. Purchases FHA, DVA and conventional loans
 - C. Is the leading secondary money market for mortgage notes
 - D. All of the above
10. The following is used as the security instrument to finance a Cal-Vet loan:
 - A. Deferred deed
 - B. Land contract
 - C. Mortgage
 - D. Trust deed

*Chapter 5 Answers: 1-B, 2-B, 3-D, 4-C, 5-B, 6-D, 7-B, 8-A, 9-D,
10-B*

CHAPTER 6: HARD MONEY LOANS & CONVENTIONAL LOANS



PREVIEW

This chapter covers conventional loans, their advantages and disadvantages, and how to compare one lender with another. Buy-down loans are explained, and several examples are given. The California Fair lending Regulations are outlined and analyzed. The chapter concludes with a discussion of private mortgage insurance companies. We will then examine conventional and non-conventional loans.

SOFT MONEY LOANS

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

HARD MONEY LOANS

HARD MONEY refers to cash. In a hard money loan, cash (generally in the form of checks) actually changes hands. The term "hard money loan" has come to mean more than just a cash loan. It is a loan made by an individual rather than institutional lender.

A **HARD MONEY MAKER** is the individual who makes the loan. While the funds used may be borrowed, the individual is at risk. Institutional lenders are not considered hard money makers.

A **HARD MONEY ARRANGER** is the person who brings the parties together, such as a real estate loan broker. The arranger finds a person

willing to put up cash secured by a lien on real property and a person willing to place a lien on real property in exchange for cash.

When we speak of hard money arrangers, we are normally speaking of arrangers between private investors, rather than institutional investors and borrowers.

SOURCES OF FUNDS

PRIVATE INDIVIDUALS

Most loan funds are from personal or business savings. Some loan arrangers have sought investors owning homes with very low debt-to-equity ratios, as well as owner's of debt-free residences. By refinancing, they are often able to borrow at a much lower interest rate. They are able to make money on this interest differential by trading on their equity. Even if their loans are well secured, the investor in such a situation is at risk. Should the lien that they hold go into default, they may not have the funds to make their own mortgage payments, which would place their home at risk of foreclosure.

PENSION FUNDS

Pension funds are not taxed on earnings so theoretically they should be able to make investments with lesser yields. In practice, pension funds are being pushed to perform well.

Pension funds have discovered real property secured loans as an acceptable balance between risk and yield. Both private individuals and private pension funds can avoid the usury limitations and receive higher rates of interest by using brokers as arrangers of their loans. If they made the loans direct, the usury law would apply. Public pension plans are exempt from usury limitations as are other licensed lenders.

Disclosure statements as to the particulars of a loan being offered that is secured by real estate is required. Disclosures need not be given to trustees of pension, profit sharing or welfare funds having assets of \$15 million or more. Pension funds with less than \$15 million in assets are treated as other non-institutional lenders. These pension funds receive the protection of required disclosures.

Persons who are borrowers on these hard money loans are generally willing to pay interest charges greater than they would have to pay from institutional lenders because, for a variety of reasons, they are unable to obtain financing from banks or savings bank institutions.

LOAN CHARACTERISTICS

INCOME

Income indicates a borrower's capacity to make loan payments. The income figures should be obtained from the borrower and verified where possible. Verification might be from the borrower's paycheck stubs or copies of prior income tax returns. Information of the income and what verification was made must be given to the lender. Reported income on tax returns for owners of small businesses may be less significant to a lender than wage income.

In cases of under-reporting of income to defraud the government, small business owners frequently jeopardize their position when conventional lenders will not grant them purchase or equity loans because the small business owners lack the capacity (on paper) to repay the loan.

ASSET BASED

Loans are secured by real property.

☞ The value of the real property is the primary criteria for making the loan.

The lender, while generally preferring performance from the borrower, wants to know that in a worse-case scenario (foreclosure) he or she is protected. The following factors are of far lesser importance.

POOR CREDIT

A history which indicates problems in the past will deter most conventional lenders. Since hard money makers are primarily interested in security, many will make loans in cases where the borrower appears risky and even likely to default if the property value warrants the loan. Some hard money lenders are also dealers in real property. These lenders will make loans in situations where they would be delighted if the borrower defaulted and they ended up owning the property.

CREDIT DISCLOSURE

Even though a loan may be based on asset value, the arranger of hard money loans has a duty to protect and fully inform lenders and borrowers. Credit of a borrower must be checked out. Assuming that a borrower has financial strength based on his or her possessions and lifestyle could result in loan broker liability. The normal procedure is to obtain a report from a credit reporting agency. If the report is insufficient, such as no reported credit history, the loan arranger should request an investigative report.

☞ *The credit information must be disclosed to the lender.*

PURCHASE MONEY LOANS

PURCHASE MONEY LOANS are loans to purchase real property. It is an equity-based purchase loan.

☞ *Most purchase money loans are made by institutional lenders who offer significantly lower loan costs and interest rates.*

Some of the reasons hard money arrangers get involved in purchase money loans include:

- ♦ **Property Type** - Most institutional lenders are not interested in loans on raw land or lots. It is often difficult to obtain loans on special purpose buildings or properties considered distressed.
- ♦ **Capacity** - Due to outstanding debt or low income, a person might not meet the proper ratio requirements of income to debt service costs. In reality, people can often afford what they want. In Orange County, many people pay over 50 percent of their income to live in a desirable area.

Ratios are more likely to be used as a guide by hard money lenders rather than as a rule that has been cast in stone.

- ♦ **Credit** - Prior credit problems because of personal problems or just neglect disqualify many buyers from conventional loans. Hard money lenders are less likely to be concerned with minor credit problems and sometimes they are not terribly concerned with major problems.

EQUITY-BASED LOANS

EQUITY-BASED LOANS are loans covering a property owner's equity. Equity is the difference between all of the liens and obligations against a property and its fair market value.

☞ *The majority of hard money loans are equity-based loans.*

For reasons covered under purchase loans, borrowers frequently cannot obtain equity loans from conventional lending institutions. In addition, appraisals by lending institutions have changed. At one time, appraisals were optimistic when lenders wanted to increase loans at the expense of greater risk. The savings and loan industry suffered from loose lending with foreclosures and eventual government bailouts to protect depositors.

Today, many lenders have gone the other way and prefer to use very conservative appraisers. Some lender appraisals may vary significantly from appraisals commissioned by a loan broker.

LOANS IN EXCESS OF EQUITY (125 PERCENT MORTGAGES)

These are second mortgages that exceed the home value by 25 percent. It is estimated that \$20 billion in these loans were made in 2002. They are considered by some mortgage arrangers as a hot product. While many of the larger mortgage companies will not touch these products, some, including some of the larger ones, are actively seeking borrowers and lenders. In some cases, they are using "boiler room" techniques employing tele-marketers.

Consumers are able to use proceeds to pay off relatively short term, high interest credit card debt at interest rates of up to 21 percent and substitute a second mortgage at 13 to 14 percent interest. This creates lower monthly payments for the borrower. In addition, the interest on the second mortgage will probably be deductible for income tax purposes while paid credit card interest is not deductible. The net effect is that the effective rate of interest for the borrower is lowered significantly.

These loans are risky to the purchaser in that borrowers who fail to avoid excessive credit card debt are likely to get into trouble again. If foreclosure becomes necessary, the lender will have no security for funds lent in excess of the homeowner's equity.

A few mortgage companies are making these loans and packaging them in large bundles. They are then sold on the secondary mortgage market. The large number of loans is believed to reduce the risk.

Investors should be made fully aware of the fact that loan funds in excess of borrower's equity is in reality unsecured loans. These loans are likely being made to persons who, in the past, have spent themselves into debt which they could not handle.

CHARACTERISTICS OF HARD MONEY LOANS

HIGHER INTEREST RATES

Loans made by hard money lenders bear interest rates higher than rates charged by institutional lenders.

Risk is related to rate. No one will invest money in a higher risk investment unless the greater risk was compensated for in return. As an

example, the most risk free long-term investment is government bonds which also provide the lowest rate of return of any long-term investment.

SHORTER TERMS

Loans made by hard money lenders are more likely to have a shorter repayment term than are loans made by institutional lenders.

NON-AMORTIZED

Loans made by hard money lenders are more likely to have a balloon payment than loans made by institutional lenders.

FIXED RATE

☞ Relatively few hard money loans have adjustable rates.

The reason being that the interest rates are quite high to begin with, and hard money lenders who have a few loans do not want to be bothered with the accounting required to handle adjustable rate loans. (The loan could be serviced by a firm set up to handle adjustable rate loans.)

INVESTOR PROTECTION

The most important lending criteria for hard money lenders is the value of the property securing the loan.

☞ As a rule of thumb, the loan-to-value ratio should not exceed 70 percent.

With a 70 percent ratio, the lender should not suffer a loss if the borrower defaults on loan payments. The 30 percent equity should be sufficient to cover the following:

- ♦ **Interest Lost** - Payments not made means lost interest.
- ♦ **Foreclosure Costs** - Besides the direct costs of foreclosure, there is the time factor to consider. The time value of money (interest) must be considered.
- ♦ **Senior Liens** - If the investor's junior lien is in default, chances are the senior liens are also in default.
- ♦ **Marketing Costs** - Marketing costs to recoup the loss involve a number of expenses.

- ♦ **Commissions** - Costs paid to a sales agent.
- ♦ **Escrow and Closing Costs** - These are normal costs involved in any sale transaction.
- ♦ **Maintenance Costs** - The property will probably have maintenance costs during the marketing period. In addition, owners in foreclosure often neglect regular maintenance and in some case are actually destructive, which could result in considerable expense.
- ♦ **Holding Costs** - Depending on the type of property, it could take six months for a sale after foreclosure. To avoid any losses, the sale proceeds should be enough to cover the taxes and insurance during this time, as well as the interest lost on the money the lender has invested. The interest will compound without the payments being made and with additional cash expenditures. Therefore, the actual lender investment has risen significantly.

Of course, there is always the risk that values will decline and/or the loan appraisal was not realistic. This could result in the lender taking a significant loss as to sale price versus loan balance in addition to the other costs listed above.

The 70 percent ratio is close to a break-even ratio based upon a sale at appraisal value. If greater security is desired by a lender, the loan can either be reduced or additional assets can be added to the security. (Note: 125 percent loans violate the 70 percent rule).

ABILITY TO SERVICE DEBT

If a hard money equity lender lacks the financial ability to make the payments (service the senior loans) and maintain the property upon which the borrowers default, then that lender should not have been a lender.

Investors must consider the "What Ifs" of an investment. Investors are taking a huge risk if default would leave them owning on a property having loan obligations beyond their payment ability.

LOAN FILE RECORD-KEEPING

At a very minimum, a hard money arranger should cover the following in his or her loan file.

Loan Application - The application should include credit information. While these are not federally related loans, the Uniform Residential Loan Application is an excellent form to use.

Credit Report - A copy of the credit report should be maintained in the file as well as a signed receipt from the lender that they received the credit information prior to funding the loan.

Verification of Mortgages - Verification should be obtained on balances on all senior encumbrances as well as on the status of senior loans.

Preliminary Title Report - A Preliminary Title Report should be obtained and a copy retained in the loan file. A receipt from the lender showing receipt of the information should also be in the file.

Appraisal - The file should include an appraisal by a licensed or certified appraiser.

☞ The broker is exposed to considerable liability if, as an arranger of the loan, he or she is also appraising the property.

A subsequent foreclosure and resale at a significantly lower figure than the appraisal might result in a lawsuit. The lender could claim either negligence or fraud. However, if the arranger of the loan does make the appraisal, it should be well-documented to stand a possible challenge by expert witnesses.

Mortgage Loan Disclosure Statement - Copies of the Lender and Purchaser Mortgage Loan Disclosure Statement should be kept on file indicating, by the signatures of the parties, that the statements were received. Mortgage Loan Disclosure Statements will be discussed in Chapter 11.

Servicing Agreement - If the arranger of credit (Mortgage Loan Broker) will not service the loan, the file should have signed documentation that the lender was so informed.

☞ Most arrangers of mortgages do not service loans they arrange.

A few do so. These are usually multi-office loan brokers who have a significant volume and are able to treat loan servicing as a separate profit base.

If the hard money arranger will be servicing the loan, the file should include a copy of the loan servicing agreement.

Example:

A prospective borrower entered into a written contract with a broker, who was to obtain a \$950,000 loan for the permanent financing of a shopping center.

The plaintiff broker obtained a loan commitment. However, the commitment introduced a condition not contemplated by the loan procurement agreement. As a condition of the loan, the lender required the limited partners to sign personally on the note and trust deed. This would override their exemption from liability, which was one of the purposes of being a limited partner.

The loan was refused on these conditions and the broker sued for a commission since a loan had been found.

The trial court held that the plaintiff had not performed as the offered loan had a condition that was reasonably unacceptable. The trial court was affirmed by the Court of Appeals.

CONVENTIONAL LOANS

Any loan that is not a government-backed loan is called a ***conventional loan***. Government backed loans were covered in Chapter 5.

A ***CONVENTIONAL LOAN*** is ***neither guaranteed or insured*** by any agency of the federal government. It may, however, be insured by a private mortgage insurance company. The guidelines for these conventional loans are set by the investor criteria, such as FNMA or FHLMC.

Most lenders prefer to lend on single family owner-occupied homes or condominiums. Conventional lenders, however, make loans not only on owner homes and one- to four-unit properties, but also on larger complexes. Property types that conventional lenders normally make loans on include larger apartment complexes, commercial shopping centers, office buildings, and industrial property. Just as many government lenders do not handle all programs, the same is true for conventional lenders, which often prefer to work with only certain types of conventional loan programs. No single conventional lender dominates the market, and a mortgage loan broker may take a borrower's application file to more than one lender. If a loan is not approved by one lender, the mortgage loan broker may obtain approval at a second or third or fourth conventional lender, since each lender sets its own loan criteria.

In today's market, many mortgage loan companies have taken the lead in offering low down payment loans to qualified buyers. The typical down payment required on many of these loans ranges from 5 to 10 percent. Many loans also offer reduced loan origination fees and expanded debt-to-income ratios.

The advantages and disadvantages of conventional loans versus government-backed loans are outlined below.

ADVANTAGES OF CONVENTIONAL LOANS

Processing Time - The processing time on a conventional loan is usually less than for a government insured or government-guaranteed loan. Under normal circumstances, the originator of the conventional loan has been given the underwriting guidelines of the investor and is allowed to approve any loan that, in the opinion of the originator, meets the guidelines. This is even true for conventional loans that are to be sold to Fannie Mae. This allows a lender to give in-house approval on Fannie Mae loans.

The actual processing time for a conventional loan can take around 30 days, or sooner if all of the information to be verified is from local sources in an active real estate market.

With computerized underwriting a conventional loan can be approved in as one week or less. It is difficult to get that type of quick service from government programs. Usually, government agencies do not have the flexibility in their procedures that a conventional lender enjoys.

This faster processing time is one of the major factors that will make the conventional mortgage more attractive to your clients.

Loan Amounts - Unlike government loans, the conventional loans or lenders have no set loan limits. This limit is usually set by the investor of the lender, unless the loan is sold off in the secondary market, as discussed in Chapter 7. But FHA sets maximum loan amounts on a home loan depending on geographical location. The DVA has no dollar loan maximum, but individual lenders do limit the veteran's loan amount because the DVA guarantees only part of the loan. Cal-Vet's maximum loan on a single-family dwelling is limited and varies from year to year. Dollar limits on government-backed loans were covered in Chapter 5.

Flexibility of Lenders - When a lender keeps a loan rather than reselling it in the secondary market, it is called a portfolio loan. Many portfolio lenders will make these loans with attractive provisions. Some may offer what is called the "Quick Qualifier" loan, requiring not much more than pay stubs to satisfy the verification requirements for loans with a large down payment. But even with very large down payments, the borrower's credit is always checked.

More Lenders Available - If you apply for a DVA-guaranteed loan and the loan is rejected by the DVA, you have no alternative lender. There is only one U.S. Department of Veterans Affairs, just as there is only a

single FHA and one California Department of Veterans Affairs. On the other hand, if a loan is turned down by one conventional lender, there are other lenders who may approve the loan. No one conventional lender has a monopoly on the market: With different lenders come different underwriters and different attitudes, so that even though they are applying the same rules, results may differ due to compensating factors.

Less Red Tape - Processing a conventional loan involves less red tape. There may be fewer forms to complete, and the routine of processing is more flexible.

DISADVANTAGES OF CONVENTIONAL LOANS

Higher Down Payments - The down payment required on a conventional loan is more than that required on either the FHA or VA loan. Most buyers use government-backed financing because it usually requires a smaller down payment than conventional loans. DVA loans do not require any down payment, although a lender may require a down payment if there is a differential between sales price and appraisal. FHA and Cal-Vet require small down payments. However, during easy money markets, conventional loans with 3 to 10 percent down payments come close to competing with government loans for low down payments.

Prepayment Penalties - FHA, DVA, and Cal-Vet loans do not have a prepayment penalty. Some conventional loans have them, but they are becoming increasingly rare.

SOURCES OF CONVENTIONAL LOANS

The main sources of conventional money are mortgage bankers and mortgage companies, commercial banks, and savings banks.

Every lender has to adhere to certain state or federal agency regulations, but beyond that, what a lender does is a matter of company policy. For example, no regulation dictates what interest rate a lender should charge. Besides interest rates, there are many other financing terms and conditions for which each lender sets its own policy, based on market judgments. This applies only if the lender is making a loan that it is going to keep in its inventory, the so-called portfolio loan.

If a conventional lender wishes to resell the loan to the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac), the lender must stick to standards established by these major loan purchasers.

BUY-DOWN MORTGAGE

A **BUY-DOWN MORTGAGE** is a fixed-term, fixed-rate mortgage that has an effective interest rate below the note rate. It serves as a method of qualifying borrowers in a high-interest rate market by discounting the effective interest rate. This reduction is accomplished by the use of an impound account usually established by a builder and is sometimes referred to as a **3-2-1** or a **step-mortgage**.

The reason for this type of mortgage is to lower the interest rate the borrower will pay in the first few years of the mortgage, especially in the first year of the mortgage. The importance of reducing the interest rate is that it will take less income for the borrower to qualify for the loan. The lender will receive the full principal and interest (P&I) payment as called for in the note, but there is no negative amortization because the difference between the payment made by the borrower and the amount received by the lender is taken from the impounded funds that are established at closing.

BUY-DOWN PERIOD

This is the period during which borrower will be paying an interest rate below the note rate. There is no fixed buy-down period. It can be as short as three or as long as 10 years, but many of those who purchase mortgages in the secondary market have limited the period to three years.

BUY-DOWN INTEREST RATE

Many times the real estate professional will see the buy-down advertised as 3-2-1, which means that the first year's effective interest rate to the borrower or the rate that will be used to qualify the borrower will be three percentage points below the market rate offered by the lender. Thus, the second year the rate on the borrower's effective rate would be two points below the rate on the note; and finally in the third year of the mortgage, the borrower would be paying an effective rate of 1 percent below the rate on the note. Thus, with this type of mortgage, the borrower would not pay the full note rate until the 37th payment or at the beginning of the fourth year. Why is it important to lower the first-year interest rate? This is the rate the lender will use to qualify the borrower.

In 1983, many builders and lenders began offering *deep buy-downs* extending over five to 10 years. For example, a builder might offer an 8-6-4-2 buy-down. Many of the mortgage insurers and purchasers of mortgages in the secondary market felt that this deep payment level would expose the borrower to payment shock. Under this program, the borrower would be qualified at a rate eight percentage points below the

note rate. Assuming the note rate was 13.250, the borrower would be qualified at 13.250 percent less 8 percent or 5.25 percent. This rate would increase in the second year to 13.250 less 6 percent or 7.25 percent and so on through the four year buy-down period.

Many of those who either buy mortgages in the secondary market or insure conventional mortgages have set the maximum buy-down that may be used to qualify the borrower as three below the rate expressed on the note regardless of the amount of the actual buy-down.

☞ In the current low interest rate era of the 2000s, this device is seldom used except in FHA/DVA discounting.

CALCULATION OF BUY-DOWN FUNDS

In this section we will review the methods available to calculate the funds necessary to secure a temporary payment reduction for a client.

One question that always is asked is who may pay the payment reduction funds? According to many lenders, as well as the FHA and the DVA, the funds can be provided by anyone. Most lenders will not require a gift letter from the borrower if a third party should provide a portion of the buy-down funds. The buy-down funds are in addition to any other discount points or any other fee in connection with the loan.

Now let us assume we are working with a client--either the buyer or seller--and that the client is interested in a buy-down mortgage. The mortgage amount will be \$86,550 with a term of 30 years and an interest rate of 10 percent. First, we will need to calculate the monthly payment for the mortgage at 10 percent. This can be done by consulting Figure 7.1 Amortization Table and finding the monthly payment factor for a 30-year loan at 10.00. We then multiply the monthly payment factor, 8.78 (more actuarially 8.7757), by the loan amount expressed in thousands or

$$8.77757 \times 86,550 / 1,000 = \$759.54 \text{ (P\&I)}$$

This will be the amount of the *P* & *I* payment the lender will receive each month, irrespective of the amount the borrower pays.

The second step is to calculate the interest rate the borrower will be paying for each of the 3 years.

$$\begin{aligned} \text{Year 1 of the buy-down is the note rate less 3 percent or} \\ 10.00 - 3 = 7.00 \end{aligned}$$

This will be the rate that will be used to qualify the borrower.

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Year 2 is the note rate less 2 percent or, $10.00 - 2 = 8.00$

Year 3 is the note rate less 1 percent or $10.00 - 1 = 9.00$

The third step is to calculate the actual dollars that will be required to fund or to be impounded to supplement the borrower's payment to the level required by the lender or \$759.54. This amount may be calculated using two different methods. One method is sometimes referred to as the fast-and-dirty method. Using this method, we add up the percent of buy-down each year, in this case $3 + 2 + 1$ or a total of 6 percent. This amount is then multiplied by the loan amount of the loan amount is multiplied by each of the percentages.

$\$86,550 \times 3\% =$	\$2596.50
$\$86,550 \times 2\% =$	\$1731.00
$\$86,550 \times 1\% =$	\$865.50
Total required	\$5193.00

The second method used to calculate the buy-down funds is sometimes referred to as the *actual cash method*. The actual difference between the monthly payment made by the borrower and the monthly payment required by the lender is calculated for each year of the buy-down.

This would be calculated as follows:

Year 1

Interest rate paid by borrower: 7.00

Monthly payment of borrower: \$575.82

Monthly payment required by lender: \$759.54

Difference between payments: $\$759.54 - \$575.82 = \$183.72 \times 12 = \$2204.64$

Year 2

Interest rate paid by borrower: 8.00

Monthly payment of borrower: \$635.07

Monthly payment required by lender: \$759.54

Difference between payments: $\$759.54 - \$635.07 = \$124.47 \times 12 = \$1493.64$

Year 3

Interest rate paid by borrower: 9.00

Monthly payment of borrower: \$696.40

Monthly payment required by lender: \$759.54

Difference between payments: $\$759.54 - \$696.40 = \$63.14 \times 12 = \$757.68$

Total funds required:

$$\$2204.64 + \$1,493.64 + \$757.68 = \$4455.96$$

You will note there is a difference between the two figures of approximately \$737.04. The supplier of the buy-down funds, would seek a lender that calculates the buy-down funds using the actual cash method.

LOW DOWN PAYMENT CONVENTIONAL LOANS

Both the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation recognize that accumulating a down payment and the required closing costs keeps many people from buying a home. To help this situation, both have created several low down payment programs. Although there are minor differences between Fannie Mae and Freddie Mac, the popular Fannie/ Freddie 97 programs is as follows:

- ♦ A down payment of only three percent is required, meaning a 97 percent loan-to-value (LTV) loan is granted.
- ♦ Income qualifying ratios are easier. Borrowers must have an excellent credit history.
- ♦ Borrowers must attend a home buyer educational seminar.
- ♦ In some cases there may be an income level requirement for the borrower (these limits are more generous in California than in most other states.)
- ♦ The loan can be used to buy only single-family, principal residences, including condos, planned unit developments, and manufactured homes attached to a permanent foundation.

Another popular Fannie Mae/Freddie Mac offering is called the **Community Home Buyer's Program**. This plan is designed especially to help low- and moderate-income home buyers and features what is called the 3/2 option. The 3/2 Option provides for a low five percent down payment, but with a twist. It allows borrowers to put only three percent of their own money toward a down payment. The other two percent may be obtained from family gifts or by means of a grant or loan from the state, a local government agency, or a nonprofit organization.

Traditional credit standards are required, but other underwriting criteria are eased to qualify applicants, with greater emphasis on stable job history, steady rent and utility payments, and a ceiling on the qualifying income level, since the program is limited to those less affluent. Though creditworthiness is always important, a greater percentage of applicant's gross monthly income may be used to meet mortgage payments. Because

of the high loan-to-value ratio, the 3/2 option loans must be covered by private mortgage insurance, discussed later. But with what amounts to 97 percent financing, coupled with reduced closing costs and cash reserve requirements, more families may find the dream of home ownership achievable.

PRIVATE MORTGAGE INSURANCE

PRIVATE MORTGAGE INSURANCE is an insurance policy issued from a licensed company to an approved lender, protecting that lender from financial loss due to the default of a borrower. This insurance is issued only on first-lien mortgages secured by improved residential property. Usually the insurance is only issued on mortgages that exceed **80 percent** of the appraised value of the property.

☞ *PMI has become a viable alternative to FHA insurance.*

PMI COVERAGE

TYPES OF PROPERTIES

As a real estate professional, you should have knowledge of the types of properties and the amount of insurance available. All PMI companies will normally issue policies on first-lien mortgages on a one- to four-family dwelling used as a primary residence where the loan does not exceed 95 percent of the appraised value. Some PMI companies will issue mortgage insurance on a mortgage for a second home or a leisure home. In this case, the loan may not exceed 80 percent of the appraised value. Some PMI companies will issue insurance on mortgages of one- to four-family dwellings that are not the primary residence, but are held as investment property. For the investment property, the loan-to-value ratio generally should not exceed 80 percent. Not only will PMI companies issue insurance on single family dwellings, but some of the companies will issue mortgage insurance on manufactured housing. To get the details on this coverage, you will have to contact the various PMI companies to see if they issue this type of insurance. Due to losses recently suffered in the industry based upon improper appraisal techniques and poor underwriting, PMI companies are establishing stricter guidelines in the areas of negative amortized loans and accepting insurance applications on condominiums and planned unit developments.

INSURANCE ISSUED

Many references have been made to issuance of insurance by the PMI company on mortgages, but what is the coverage of the insurance? First,

PMI insurance is not the same as the insurance issued by FHA. PMI does not insure 100 percent of the mortgage, but only a portion of the mortgage. The PMI companies are limited by law to the maximum percent of the loan they can insure.

The normal protection for a fixed-term, fixed rate mortgage is between 20 and 30 percent, and for an adjustable-rate mortgage the coverage is between 20 and 35 percent. This protection is available on a high loan-to-value ratio loan of 80 percent or more and issued almost exclusively on 90 to 95 percent loans. With this type of coverage available, institutions that are limited to a maximum loan-to-value ratio of 75 percent are able to make 95 percent loans. With the 25 percent coverage on a fixed-term, fixed-rate 95 percent loan on a home selling for \$70,000, the lender would have the following risk:

Sales price	\$70,000
Loan amount-95%	\$66,500
Borrower's down payment	\$ 3,500
Loan amount	\$66,500
PMI Coverage	X25%
Total PMI coverage	\$16.625

Thus, the lender's exposure on the property would be the sales price, less the down payment, less the insurance coverage, or:

$$\$70,000 - \$3,500 - \$16,625 = \$49,875$$

When the items are subtracted from the sales price and the lender's exposure of \$50,000 is divided by the sales price, the lender is actually making a 71.25 percent loan.

$$\$49,875 / \$70,000 = 71.25 \text{ percent}$$

In addition to the 25 percent coverage on the fixed-rate loans, many of the PMI companies offer 12-, 16-, 17-, 20-, 22-, 25-, and 30-percent coverage. In regard to the adjustable-rate mortgage, many of the companies offer 20-, 25-, 30-, and 35-percent coverage.

These are the standard coverages that many of the lenders will require on many of the loans they originate or fund. If the mortgage is to be sold to Fannie Mae or FHLMC, however, the required overages are as follows:

Fixed-rate mortgage

91 to 95% loans	22% coverage
86 to 90% loans	17% coverage

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81 to 85% loans	12% coverage
80% and under	No coverage

Loans with possible negative amortization

91 to 95% loans	25% coverage
All other loan/value ratios	20% coverage

One can see that normally Fannie Mae and FHLMC require less coverage, thus increasing the lender's exposure slightly.

Let us use the same example as before and calculate the lender's exposure to loss through Fannie Mae or FHLMC.

Sales price	\$70,000
Loan amount-95%	\$66,500
Borrower's down payment	\$ 3,500
Loan amount	\$66,500
PMI Coverage	X22%
Total PMI coverage	\$14,630

Once again, the lender's exposure to loss would be the sales price, less the down payment, less the PMI coverage or-

$$\$70,000 - \$3,500 - \$14,630 = \$51,870$$

This would have the lender actually making a 74.1 percent loan, increasing the lender's exposure by less than 3 percent.

The coverage discussed above are only the basic, and many are available. As a real estate professional, you will normally deal only with the coverages outlined above.

PMI PREMIUMS

PMI companies' operations and rates are monitored by the State of California Insurance Commissioner. Competition, however, keeps them relatively uniform.

Generally, PMI companies insure loans on one to two units up to 97 percent and on three to four units up to 90 percent. Figures can vary from company to company and the following examples are for illustration purposes only.

1. **Loans over 80 and up to 85 percent loan-to-value coverage** - The insurance ordinarily covers the top 12

percent of the loan amount. To keep it simple, if a home sold for \$100,000 and the loan was 85 percent or \$85,000, the coverage would be 12 percent of \$85,000 = \$10,200. The lender's exposure is \$74,800, or 75 percent.

- **Premiums** - If annual premiums are utilized, the fee due at close of escrow would be about .29 percent of \$85,000, or about \$246, and monthly collections thereafter would be \$20.54. If monthly premiums are utilized, there may be no advance collection at close of escrow, and the premiums based on .32 percent would be \$22.67.
2. **Loans above 85 and up to 90 percent loan-to-value coverage** - the insurance ordinarily covers the top 25 percent of the loan amount. If a home sold for \$100,000 and the loan was 90 percent or \$90,000, the coverage would be 25 percent of \$90,000 = \$22,500. Lender's exposure is \$67,800 or 68 percent.
- **Premiums** - If annual premiums are utilized, the fee due at close of escrow would be about .49 percent of \$90,000, or about \$441, and monthly collections thereafter would be \$36.75. If monthly premiums are utilized, there may be no advance collection at close of escrow, and the premiums based on .52 percent would be \$39.
3. **Loans above 90 and up to 97 percent loan-to-value coverage** - The insurance ordinarily covers the top 30 percent of the loan amount. If a home sold for \$100,000 and the loan was 95 percent or \$95,000, the coverage would be 30 percent of \$95,000 = \$28,500. Lender's exposure is \$66,500 or 67 percent.
- **Premiums:** If annual premiums are utilized, the fee due at close of escrow would be about .75 percent of \$95,000, or about \$712, and monthly collections thereafter would be \$59.38. If *monthly* premiums are utilized, there may be no advance collection at close of escrow, and the premiums based on .78 percent would be \$61.75.

There are other variations of fees and annual premiums, as well as plans whereby you can pay one fee at the time of closing and no annual premium. Whether premiums are paid on the basis of 1/12th of an annual

premium or merely on a monthly premium basis, the amounts are ordinarily collected by the lender with monthly impounds of taxes and insurance.

Some lenders will, as an alternative, insure the loan using PMI that the lender pays for by increasing its loan interest rate. In this case, the lender's quoted rate includes the PMI premiums, but since it is, in fact, an interest rate, it is deductible under IRS rules. If the lender charges an interest rate plus the PMI premium, then only the interest is deductible, and the insurance premium is not.

Offsetting this advantage or disadvantage (depending upon how long the borrower resides in the property) is the fact that when the lender includes the PMI in its rate, the payments will never change, even when the loan-to-value drops below 80 percent and the PMI coverage is dropped. At that point, the lender's yield increases by the amount of premium no longer paid. On the other hand, when the lender charges a rate plus a premium, the borrower's payment will decrease when loan-to-value declines to 78 percent or below, and PMI is no longer required. For short-term ownership, being able to deduct it all as interest may be advantageous. For long-term ownership, the likelihood that payments will someday decrease may be the better choice.

In California, the Civil Code allows residential borrowers to cancel PMI after two years if the loan-to-value ratio is 78 percent of the current market value. Under federal law, for all new insured loans originated after January, 1999, all lenders on FHA insured loans must cancel the MIP coverage when there is at least a 22 percent home equity. This 22 percent equity must be shown by an official appraisal, the borrower must have a good payment history, and the loan must be on the books for at least two years.

Appreciation, not just principal pay down, counts to measure the 22 percent or more equity. {Note: Both the California and federal laws cover only *new* insured loans granted from January 1998 for the state law, and January 1999 for the federal law, but not loans already on record prior to those dates. In both cases, FHA mortgage insurance (MIP) cannot be cancelled.}

APPLICATION FOR PMI

Each of the PMI companies has its own application procedures. Usually lenders submit a completed loan package to the PMI Company. The application package is reviewed and approved or denied.

Generally, PMI companies have standard underwriting guidelines concerning the relationship of the total monthly income to the total

mortgage payment, including all escrows and any fees that may affect the title to the property. In addition to the ratio of the total monthly income to mortgage payment, PMI companies review the ratio of the total monthly income to the total long-term obligations of the borrower, including the total mortgage payment. In most cases, the PMI companies define "long-term obligation" as any obligation that will take 10 or more months to pay off.

The PMI Company reviews the credit history of the borrower, his work record, and any other factor that may affect the borrower's ability or willingness to repay the obligations. Some of these factors are court judgments, pending lawsuits, and bankruptcy.

They also review the property that will serve as the security for the mortgage. The economic life of the property will be checked to see if it is sufficient to support the term of the loan. Also considered is whether the property can be sold rapidly if it is taken back, and whether it is an existing construction or proposed construction. These are only a few of the guidelines used by the PMI companies. For further information, contact a PMI company and request the in-depth underwriting guidelines they use.

If all of the underwriting guidelines are met and the PMI Company issues the requested coverage, the originating lender will be notified by phone, and later a written confirmation of the approval will be furnished. This underwriting procedure will normally take only one or two days. Underwriting by PMI companies is a great deal faster than that of FHA, which can take many weeks.

CLAIMS PAYMENT

When a lender has notified the PMI Company that an insured loan is in default, the insuring company has two ways of handling the claim. It can pay the lender the full amount of the remaining loan balance. If this is done, the PMI Company takes title and then dispose of the property. Or it can pay the lender as per the coverage purchased (20, 25, or 10 percent of the loan balance) plus other expenses in the policy of the PMI company, and the lender will then dispose of the property.

Claims under insurance issued by a PMI company are handled differently from claims filed against FHA mortgage insurance. The FHA will pay the lender the outstanding loan balance either in cash or debentures secured by the United States Treasury and FHA will take the property.

If a foreclosure occurs on a property that is insured, the PMI company either:

- ♦ Pays off the lender in full and takes title to the property, or
- ♦ Pays the lender in accordance with the insurance, usually 20 to 25 percent of the principal balance plus certain expenses. The lender then keeps the property and is responsible for selling it.

BENEFITS OF PMI COVERAGE

There are many benefits for both the borrower and the lender with the purchase of PMI coverage.

- ♦ Advantages to the lender:
 1. The PMI insurance allows the lender to make 90 and 95 percent loans and to sell these loans in the secondary market.
 2. With the ability to make higher loan-to-value ratio loans, the amount of possible loans is expanded.
 3. The lender can secure an additional amount of security for the loan at no extra cost.
 4. The processing time and the issuance of the insurance commitment is usually faster from a PMI company than the FHA.
- ♦ Advantages for the borrower:
 1. The borrower has the ability to purchase a home with a conventional loan with as little as 5 percent down payment.
 2. With the need for less money down, the borrower can buy a home sooner and sometimes larger than expected.
 3. The processing time for the insurance commitment is usually faster than with the FHA.
 4. The payment of the insurance premiums is for a shorter period than FHA.

CHAPTER 6 QUIZ

1. Which of the following is a hard money loan?
 - A. A purchase money loan made by an institutional lender
 - B. Seller carryback financing
 - C. Assuming existing loans with no balance
 - D. A loan arranged by a mortgage loan broker

2. The most important criteria used by lenders of hard money loans would be the borrowers:
 - A. Equity
 - B. Credit history
 - C. Job
 - D. History

3. Reasons why institutional lenders reject loan applications include:
 - A. Borrower's capacity to make payments
 - B. Borrower's credit history
 - C. The type of property the loan is sought on
 - D. All of the above

4. Characteristics of hard money loans, as compared with loans made by institutional lenders, are:
 - A. Shorter terms
 - B. Higher rate of interest
 - C. Non-amortized
 - D. All of the above

5. Hard money lending is not without risk. Risks include:
 - A. Foreclosure costs
 - B. Costs associated with delinquent senior liens
 - C. Marketing costs after foreclosure
 - D. All of the above

6. A non-government-backed loan is best known as a _____ loan.
 - A. Portfolio
 - B. Standard
 - C. Conventional
 - D. Normal

7. Private mortgage insurance covers what portion of the loan amount?
 - A. Upper portion of the loan
 - B. Middle portion of the loan
 - C. Lower portion of the loan
 - D. Entire loan
8. A straight conventional loan includes:
 - A. FHA insurance.
 - B. A DVA guaranty.
 - C. A private mortgage insurance agreement.
 - D. No third party insurance or guarantees.
9. If a PMI-backed conventional loan is foreclosed, the insurer may:
 - A. Pay the lender the full amount of insurance.
 - B. Pay off the lender in full and take over the property.
 - C. Either A or B.
 - D. Neither A nor B.
10. Chances are that you would get the lowest loan to value ratio loan using:
 - A. FHA financing
 - B. A VA loan
 - C. A Cal-Vet loan
 - D. Conventional financing

*Chapter 6 Answers: 1-D, 2-A, 3-D, 4-D, 5-D, 6-C, 7-A, 8-D, 9-C,
10-C*

CHAPTER 7: LOAN PAYMENTS & SECONDARY MARKETS



PREVIEW

This chapter covers the types of mathematical concepts most applicable to the real estate financing process. We will explore the differences between a straight note and an amortized note, and discuss the secondary market activities. Mortgage loan brokers are engaged in the primary mortgage market when they make a loan, and in the secondary mortgage market when they sell the loan.

LOAN PAYMENT CHARACTERISTICS

A loan can be repaid in various ways: all at once, in equal installments, or by some other method. In most cases there will be interest as well as principal to repay.

AMORTIZED LOAN

A loan which is **AMORTIZED** will have equal periodic payments, which are calculated to pay off the loan in full at the end of the term. **Level payment plan** is another name for an amortized loan. Monthly payments include both principal and interest. Interest is computed on the unpaid principal balance.

Example

A borrows \$5,000 from B to be repaid over 5 years, at 14 percent interest with monthly payments to include both principal and interest on a fully amortized basis. Monthly payments of \$116.35 (from amortization table or financial calculator) will be made for 60 months or 5 years, at which time the loan and interest will be fully paid.

monthly payment	\$116.35
principal & interest	\$6,981

REAL ESTATE FINANCE

principal	\$5.000
total interest paid	\$1,981

Interest is calculated from month to month on the unpaid principal balance (simple interest).

Loan Term - The length of the loan can vary, typically from 3 to 30 years. For the same amount of money, the longer the term of the amortization, the smaller the amount of each periodic payment, although terms beyond 30 years provide very little reduction in payments.

Many borrowers now are opting for 15-year amortization periods, which greatly reduces total interest costs.

Example

Compare the results of a \$150,000 loan amortized over 30- and 15-year periods at the same 10 percent interest rate.

Term	Monthly Payment	Total of Payments	Total Interest
30 years	\$1,316.36	\$473,889	\$323,889
15 years	\$1,611.91	\$290,143	\$140,143

PARTIALLY AMORTIZED

A **PARTIALLY AMORTIZED LOAN** is one where monthly payments cover interest and some of the principal, but are not large enough to repay all of the principal during the term of the loan. Also referred to as a "**balloon payment**" loan.

- ♦ **Balloon Payment** - In a partially amortized loan, the last payment calls for all the remaining principal balance due (balloon payment). California real estate law, where applicable, defines a balloon payment as one "greater than twice the amount of the smallest installment."
- ♦ **Interest** - Interest is computed on the unpaid balance.

STRAIGHT NOTE

In a **STRAIGHT NOTE**, only the interest is paid during the life of the note. The entire principal is due at the end of the loan term. Also referred to as "**interest only**."

Example

A borrows \$2,000 from B for a two-year period. The interest rate is 12 percent per annum, payable quarterly, with the entire principal due and payable at the end of the two-year term.

Payments would be made as follows:

1st Year		2nd Year	
end 1st qtr.	\$60	end 1 st qtr.	\$60
end 2nd qtr.	\$60	end 2nd qtr.	\$60
end 3rd qtr.	\$60	end 3rd qtr.	\$60
end 4th qtr.	\$60	end 4th qtr.	\$2,060

(All interest and principal is paid in full.)

NEGATIVE AMORTIZATION

In a **NEGATIVE AMORTIZED LOAN**, the monthly payment is less than the amount due for the monthly interest, the amount of the deficiency is added to the principal debt. This is most likely to occur with adjustable rate mortgages (ARM) with a payment cap.

AMORTIZATION TABLE

Amortization table is not a simple percentage calculation. It is normally derived from tables which summarize a complex arithmetic, or it can be calculated using a computer or calculator with amortization capacity. The amortization tables on next page give the numbers applicable to a \$1,000 loan at various interest rates and various times. A full book of amortization tables would give the figures for loans of different amounts, making the loan amount in the fourth variable. The four variables used in compiling the tables are *loan amount*, *interest rate*, *loan term*, and *monthly payment*. Below is the procedure for finding one factor when the other three are given.

TO DETERMINE PAYMENT

An \$11,000 loan is to be amortized over a period of 18 years with 14 percent interest. What would be the approximate monthly payment?

Locate the term of the loan in the first vertical column, 18 years, then proceed across to the appropriate interest rate column (14 percent). The figure at the intersection (\$12.70) indicates the monthly payment per \$1,000 of loan. For a loan of \$11,000, $\$12.70 \times 11 = \$139.70$ per month (principal and interest).

TO DETERMINE INTEREST RATE

A \$10,000 loan is to be amortized over seven years with monthly payments of \$176.60. What is the annual interest rate?

Find the monthly payment per \$1,000 by dividing the monthly payment of \$176.60 by 10 which equals \$17.66. Go down the column to 7 years, across to 17.66, and up to 12 percent.

TO DETERMINE INTEREST PAID

A \$14,000 loan is to be amortized over 20 years with equal monthly payments which include 13 percent interest. Approximately how much interest will be earned by the lender?

Determine the monthly amortization payment: down term of years to 20; across to the 13 percent interest rate column to \$11.72, multiply 14 (thousands) $\times$ \$11.72 = \$164.08 per month. Determine the total interest paid: 20 years $\times$ 12 months = 240 payments made; 240 payments $\times$ 164.08 per month = \$39,379.20. Total interest paid less amount of original loan equals the approximate interest earned (\$39,379.20 - \$14,000.00) = \$25,379.20

Figure 7-1 Amortization Table

TABLE OF MONTHLY PAYMENTS TO AMORTIZE \$1,000 LOAN

Terms of years	5%	5.5%	6%	6.5%	6.6%	7%	7.5%	8%	8.25%	8.5%	8.75%	9%	9.25%	9.5%	9.75%	10%
5	18.88	19.11	19.34	19.57	19.62	19.81	20.04	20.28	20.40	20.52	20.64	20.76	20.88	21.01	21.13	21.25
6	16.11	16.34	16.58	16.81	16.86	17.05	17.30	17.54	17.66	17.78	17.90	18.03	18.15	18.28	18.40	18.53
7	14.14	14.38	14.61	14.85	14.90	15.10	15.34	15.59	15.71	15.84	15.96	16.09	16.22	16.35	16.47	16.61
8	12.66	12.90	13.15	13.39	13.44	13.64	13.89	14.14	14.27	14.40	14.52	14.66	14.78	14.92	15.04	15.18
9	11.52	11.76	12.01	12.26	12.31	12.51	12.77	13.02	13.15	13.28	13.41	13.55	13.68	13.81	13.94	14.08
10	10.61	10.86	11.11	11.36	11.41	11.62	11.88	12.14	12.27	12.40	12.53	12.67	12.80	12.94	13.08	13.22
11	9.87	10.12	10.37	10.63	10.68	10.89	11.15	11.42	11.55	11.69	11.82	11.97	12.10	12.24	12.38	12.52
12	9.25	9.51	9.76	10.02	10.08	10.29	10.56	10.83	10.96	11.11	11.24	11.39	11.52	11.67	11.81	11.96
13	8.74	8.99	9.25	9.52	9.57	9.79	10.06	10.34	10.47	10.62	10.75	10.90	11.04	11.19	11.33	11.48
14	8.29	8.55	8.82	9.09	9.14	9.36	9.64	9.92	10.06	10.20	10.34	10.49	10.64	10.79	10.93	11.09
15	7.91	8.17	8.44	8.72	8.77	8.99	9.28	9.56	9.70	9.85	10.00	10.15	10.29	10.45	10.59	10.75
16	7.58	7.85	8.12	8.40	8.45	8.63	8.96	9.25	9.40	9.55	9.69	9.85	10.00	10.15	10.30	10.46
17	7.29	7.56	7.84	8.12	8.17	8.40	8.69	8.99	9.13	9.29	9.44	9.59	9.74	9.90	10.05	10.22
18	7.04	7.31	7.59	7.87	7.93	8.16	8.45	8.75	8.90	9.06	9.21	9.37	9.52	9.68	9.84	10.00
19	6.81	7.08	7.37	7.65	7.71	7.95	8.25	8.55	8.70	8.86	9.01	9.17	9.33	9.49	9.65	9.82
20	6.60	6.88	7.17	7.46	7.52	7.76	8.06	8.37	8.52	8.68	8.84	9.00	9.16	9.33	9.49	9.66
21	6.42	6.70	6.99	7.29	7.35	7.59	7.90	8.21	8.36	8.53	8.68	8.85	9.01	9.18	9.34	9.51
22	6.26	6.54	6.84	7.13	7.19	7.44	7.75	8.07	8.22	8.39	8.55	8.72	8.88	9.05	9.21	9.39
23	6.11	6.40	6.69	7.00	7.06	7.30	7.62	7.94	8.10	8.27	8.43	8.60	8.76	8.93	9.10	9.28
24	5.97	6.27	6.56	6.87	6.93	7.18	7.50	7.83	7.99	8.16	8.32	8.49	8.66	8.83	9.00	9.18
25	5.85	6.15	6.45	6.76	6.82	7.07	7.39	7.72	7.88	8.06	8.22	8.40	8.56	8.74	8.91	9.09
26	5.74	6.04	6.34	6.65	6.72	6.97	7.30	7.63	7.79	7.96	8.14	8.31	8.48	8.66	8.83	9.01
27	5.64	5.94	6.24	6.56	6.62	6.88	7.21	7.55	7.71	7.88	8.06	8.23	8.41	8.58	8.76	8.94
28	5.54	5.84	6.16	6.48	6.54	6.80	7.13	7.47	7.64	7.81	7.99	8.16	8.34	8.52	8.70	8.88
29	5.45	5.76	6.08	6.40	6.46	6.73	7.06	7.40	7.57	7.75	7.92	8.10	8.28	8.46	8.64	8.82
30	5.37	5.68	6.00	6.33	6.39	6.66	7.00	7.34	7.51	7.69	7.87	8.05	8.23	8.41	8.59	8.78
35	5.05	5.38	5.71	6.05	6.13	6.39	6.75	7.11	7.29	7.47	7.65	7.84	8.03	8.22	8.41	8.60
40	4.83	5.16	5.51	5.86	5.93	6.22	6.59	6.96	7.14	7.33	7.52	7.71	7.91	8.10	8.30	8.49

TABLE OF MONTHLY PAYMENTS TO AMORTIZE \$1,000 LOAN (Cont'd)

Term of Years	10%	10.25 %	10.5%	10.75 %	11%	11.25 %	11.5%	11.75 %	12%	12.25 %	12.5%	12.75 %	13%	13.25 %	13.5%	14%	15%
5	21.25	21.37	21.49	21.62	21.74	21.87	21.99	22.12	22.25	22.37	22.50	22.63	22.75	22.88	23.01	23.27	23.79
6	18.53	18.65	18.78	18.91	19.04	19.16	19.29	19.42	19.55	19.68	19.81	19.94	20.07	20.21	20.34	20.61	21.15
7	16.61	16.73	16.86	16.99	17.12	17.25	17.39	17.52	17.65	17.79	17.92	18.06	18.19	18.33	18.47	18.74	19.30
8	15.18	15.31	15.44	15.57	15.71	15.84	15.98	16.12	16.25	16.39	16.53	16.67	16.81	16.95	17.09	17.37	17.95
9	14.08	14.21	14.35	14.49	14.63	14.76	14.90	15.04	15.18	15.33	15.47	15.61	15.75	15.90	16.04	16.33	16.92
10	13.22	13.35	13.49	13.63	13.78	13.92	14.06	14.20	14.35	14.49	14.64	14.78	14.93	15.08	15.23	15.53	16.13
11	12.52	12.66	12.80	12.95	13.09	13.24	13.38	13.53	13.68	13.83	13.98	14.13	14.28	14.43	14.58	14.89	15.51
12	11.96	12.10	12.24	12.39	12.54	12.68	12.83	12.98	13.13	13.29	13.44	13.59	13.75	13.90	14.06	14.37	15.01
13	11.48	11.63	11.78	11.92	12.08	12.23	12.38	12.53	12.69	12.84	13.00	13.15	13.31	13.47	13.63	13.95	14.60
14	11.09	11.23	11.38	11.54	11.69	11.85	12.00	12.16	12.31	12.47	12.63	12.79	12.95	13.11	13.28	13.61	14.27
15	10.75	10.90	11.05	11.21	11.37	11.52	11.68	11.84	12.00	12.16	12.33	12.49	12.65	12.82	12.98	13.32	14.00
16	10.46	10.62	10.77	10.93	11.09	11.25	11.41	11.57	11.74	11.90	12.07	12.23	12.40	12.57	12.74	13.08	13.77
17	10.22	10.37	10.53	10.69	10.85	11.02	11.18	11.35	11.51	11.68	11.85	12.02	12.19	12.36	12.53	12.87	13.58
18	10.00	10.16	10.32	10.49	10.65	10.82	10.98	11.15	11.32	11.49	11.66	11.83	12.00	12.18	12.35	12.70	13.42
19	9.82	9.98	10.14	10.31	10.47	10.64	10.81	10.98	11.15	11.33	11.50	11.67	11.85	12.03	12.20	12.56	13.28
20	9.66	9.82	9.98	10.15	10.32	10.49	10.66	10.84	11.01	11.19	11.36	11.54	11.72	11.89	12.07	12.44	13.17
21	9.51	9.68	9.85	10.02	10.19	10.36	10.54	10.71	10.89	11.06	11.24	11.42	11.60	11.76	11.96	12.33	13.07
22	9.39	9.55	9.73	9.90	10.07	10.25	10.42	10.60	10.78	10.96	11.14	11.32	11.50	11.69	11.87	12.24	12.99
23	9.28	9.44	9.62	9.79	9.97	10.15	10.33	10.51	10.69	10.87	11.05	11.23	11.42	11.60	11.79	12.16	12.92
24	9.18	9.35	9.52	9.70	9.88	10.06	10.24	10.42	10.60	10.79	10.97	11.16	11.34	11.53	11.72	12.10	12.86
25	9.09	9.26	9.44	9.62	9.80	9.98	10.16	10.35	10.53	10.72	10.90	11.09	11.28	11.47	11.66	12.04	12.81
26	9.01	9.19	9.37	9.55	9.73	9.91	10.10	10.28	10.47	10.66	10.84	11.03	11.22	11.41	11.60	11.99	12.76
27	8.94	9.12	9.30	9.49	9.67	9.85	10.04	10.23	10.41	10.60	10.79	10.98	11.17	11.37	11.56	11.95	12.73
28	8.88	9.06	9.25	9.43	9.61	9.80	9.99	10.18	10.37	10.56	10.75	10.94	11.13	11.32	11.52	11.91	12.70
29	8.82	9.01	9.19	9.38	9.57	9.75	9.94	10.13	10.32	10.52	10.71	10.90	11.09	11.29	11.48	11.88	12.67
30	8.78	8.96	9.15	9.33	9.52	9.71	9.90	10.09	10.29	10.48	10.67	10.87	11.06	11.26	11.45	11.85	12.64
35	8.60	8.79	8.98	9.18	9.37	9.56	9.76	9.96	10.16	10.35	10.55	10.75	10.95	11.15	11.35	11.76	12.57
40	8.49	8.69	8.89	9.08	9.28	9.48	9.68	9.88	10.09	10.29	10.49	10.69	10.90	11.10	11.30	11.71	12.53

LOAN COSTS

The largest and most obvious cost of a loan is interest. A real estate loan also requires various administrative costs, deposits, and additional fees.

INTEREST

Interest is money paid to a lender for use of the lender's money. It is usually defined as a percentage of the amount borrowed.

SIMPLE AND COMPOUND INTEREST

Simple interest is the percentage charged on the unpaid principal.

Compound interest is interest on principal and accrued interest. The **nominal rate** (percentage) is specified in the promissory note.

Forces Influencing Interest Rates - Interest rates fluctuate depending upon demand and availability of the money supply and other factors. Interest rates are limited by law for some government programs.

INTEREST CALCULATIONS

The formula for interest calculations is:

$$\text{Interest} = \text{Principal} \times \text{Time} \times \text{Rate or } I = P \times R \times T$$

Example:

How much interest will be paid in 2 years on a straight loan of \$100,000 at 10 percent for 3 years?

$$I = P \times R \times T = \$100,000 \times .10 \times 2 = \$20,000$$

Example:

What is the annual rate of interest on a straight note with a principal amount of \$1,200 on which \$240 interest has been paid over a 2 years?

$$R = I / P \times T = \$240 / 1200 \times 2 = .10 \text{ or } 10 \text{ percent}$$

Example:

For how many years is a note with a principal of \$1,000 total interest of \$360 paid at a rate of 12 percent annually?

$$T = I / P \times R = \$360 / \$1,000 \times .12 = 3 \text{ years}$$

Example:

What is the principal amount of a straight note on which \$5,750 of interest has been paid over 5 years at a rate of 11.5 percent?

$$P = I / R \times T = \$5750 / .115 \times 5 = \$10,000$$

ORIGINATION FEES OR POINTS

Most lenders require these initial fees to set up loan accounts. **ONE POINT** equals 1 percent of the loan amount, a nonrecurring cost (one time charge.)

IMPOUND ACCOUNT

Impound account is a reserve account for taxes and insurance, generally set up by the lender as a convenience for the borrower, and a protection against the possibility that a buyer might default on property taxes or neglect to have the property covered by fire insurance.

The impound account is considered a trust fund. California law requires impound accounts with banks and savings and loans, on loans secured by one- to four-family residences, to pay interest at the rate of at least 2 percent simple interest per annum.

Under California law (Civil Code Section 2954), no impound account can be required as a condition of a real estate loan on a single-family owner-occupied dwelling **except**:

- ♦ Where required by state or federal regulatory authority.
- ♦ Where the loan is insured or guaranteed by the state or federal government.
- ♦ Upon failure of the owner to pay two consecutive tax installments prior to the delinquency dates.
- ♦ On loans of 90 percent or more of the sale price or appraised value.
- ♦ Whenever the combined principal amount of all loans secured by the property exceeds 80 percent.

DISCOUNT POINTS

Discount point is an additional fee on certain loans is charged by a lender to offset the difference between the loan interest rate and the current discount rate (the percentage subtracted from a loan to increase the profit to a purchaser of the loan), to make the loan competitive in the

secondary market. The greater the demand in the secondary money market, the higher the discount points will be. One discount point is roughly equivalent to adding .08 percent of prepaid interest to the nominal rate of 30 year period loan. Discount points may also be paid to buy down interest rates or to buy down the terms of an adjustable rate mortgage.

LOAN BROKER COMMISSION

For bringing together a lender and a borrower a broker may charge a fee, limited for some loans by Article 7 of the real estate law.

IMPUTED INTEREST

Imputed interest refers to interest that is considered by the IRS to have been paid for tax purposes, even if no interest payment was made. The IRS uses imputed interest as a tool to collect tax revenues on loans that don't pay interest, or stated interest is very low.

Imputed interest comes into play when someone makes a "below-market" loan. That's a loan with an interest rate below a certain minimum level set by the government, known as the Applicable Federal Rate.

Every month, the IRS publishes a list of current Applicable Federal Rates, which reflect market conditions. For example, in June 2017, the AFR for loans of less than 3 years was 1.18%. If you loan someone money at no interest, or at 0.25%, you have to deal with imputed interest.

HOW IMPUTED INTEREST WORKS

Imputed interest is interest that the tax code assumes you collected but you didn't actually collect. For example, say you loan a friend \$20,000 for one year at 0.1% interest. That friend will pay you \$20 in interest ($\$20,000 \times .001 = \$20$).

But if the AFR for that type of loan is 0.64%, then you should have collected $\$20,000 \times .0064 = \$128$. The difference ($\$128 - \$20$) \$108 is imputed interest, and you must report it as taxable income and pay taxes on it.

WHAT KINDS OF LOANS HAVE IMPUTED INTEREST

The rules for below-market loans apply to several kinds of loans:

- Gift loans—loans between friends and family members other than spouses.
- Compensation-related loans—loans from an employer to an employee or independent contractor.

- Loans from a corporation to one or more of its shareholders.
- Any loan made specifically to reduce someone's tax responsibility.
- Certain loans made to continuing care facilities under a contract.

KEY EXCEPTIONS TO THE RULES

The tax code provides a couple notable exceptions to the imputed interest rules:

- Gift loans of less than \$10,000 are exempt, as long as the money isn't used to buy income-producing assets.
- Compensation-related and corporation-shareholder loans under \$10,000 are also exempt if the lender can demonstrate that tax avoidance wasn't the purpose of the loan.

SECONDARY MORTGAGE MARKET

Loans made by mortgage bankers are customarily resold to other lenders and investors in the resale market is known as the "**SECONDARY MARKET.**"

The purpose of the secondary market is to shift funds from capital surplus areas to capital short areas. One method involves lenders selling loans to each other. Lenders also sell participating interests in blocks of loans to other lenders. Mortgage-backed securities are another tool used to obtain money from the capital market. There are securities backed by FHA and DVA loans and others backed by conventional loans.

When lenders speak about the secondary mortgage market, they are not referring to second mortgages or deeds of trust. They are talking about a market where existing loans are bought and sold.

PRIMARY AND SECONDARY MORTGAGE MARKET

*When a lender makes a loan directly to a borrower, that action takes place in the **PRIMARY MORTGAGE MARKET.** If that loan may be sold to a bank, or other investor, the sale of that loan takes place in the **SECONDARY MARKET.*** For example, if a savings bank makes a loan directly to a borrower, it is involved in the primary market. If the loan is subsequently sold to the Federal Home loan Mortgage Corporation, that sale takes place in the secondary market.

The secondary mortgage market consists of private and institutional lenders, investors, and government agencies that buy and sell mortgages to each other. In the secondary market, discounts are used constantly.

Buyers and sellers of mortgages negotiate on the basis of yield. Discounts are used to adjust yields so agreements can be reached and sales made.

PURPOSE OF THE SECONDARY MARKET

The main purpose of the secondary market is to shift money from areas where there is a surplus to areas where there is a shortage.

In the early 1970s, depository institutions sold only a small portion of the loans they originated, relying on their savings inflow to finance the loans they made. During this time, interest rates and the flow of deposits were relatively stable. As the 1970s progressed, the institutions were forced to sell more loans in the secondary market because loan volume had increased greatly. A slow rate of new deposits, typically referred to as "rate of savings inflow," was insufficient to take care of the higher demand for loans.

In the 1980s, institutions found their cost of acquiring deposits increasing dramatically. They also experienced a major outflow of deposits due to higher rates offered by competing investments such as mutual funds and certain bonds. With less money to support the demand for loans, the institutions increasingly turned to the secondary market for funds.

The mortgage banker has always operated in the secondary mortgage. Mortgage bankers do not have deposits to lend; therefore, they have to sell the loans they make to other investors. They operate as a conduit between the primary and the secondary markets. In the 1990s, almost all mortgage lenders operated in the secondary market to maintain liquidity and to stabilize the supply and demand for mortgage money.

ADDITIONAL SOURCES FOR THE SECONDARY MARKET

On a nationwide basis, deposits in institutions are insufficient to meet the demand for mortgages. To obtain additional funds for mortgages, lenders have reverted to the capital market, the market for long-term investments, which include government and corporate bonds and mortgage loans. Some of the investors in the capital market buying long-term investments are insurance companies, trusts, pension funds, and individuals.

HOW ARE MORTGAGE FUNDS SHIFTED?

There are a number of methods used in the marketplace to shift funds where they are needed. One is lenders selling loans to each other. For example, a savings bank in California may have more demand for loans than it can meet. A savings bank in Florida may have the opposite problem. The solution is to have the California savings bank sell loans to

the Florida savings bank. The California savings bank would obtain additional funds to use to make new loans, and the Florida savings bank would be investing surplus funds.

Another method is **participation**, which is to moving funds from one source to another.. Participation occurs when one institution sells a part interest in a block of loans to another institution. For example, assume the California savings bank wanted to sell \$10,000,000 in loans to the Florida savings bank. Rather than sell the entire block of loans, it could sell a 90 percent interest, or \$9,000,000. The other 10 percent share, \$1,000,000, would be retained by the lender. The California bank would continue to service the loans and pass on 90 percent of the mortgage payments to the Florida bank. FNMA and FHLMC are also actively involved with participations in 5 percent increments, purchasing 90 or 95 percent of a loan. This enables the loan seller to leverage its funds. However, FNMA and FHLMC are more often involved in the sale of "whole" loans.

MORTGAGE-BACKED SECURITIES

MORTGAGE-BACKED SECURITIES are created to make investing in mortgages as simple as buying stocks or bonds. Today the most common method used to move funds is by the use of mortgage-backed securities, which are backed by a pool of mortgages. Prior to that, lending institutions sold and purchased loans among themselves. This an inefficient and time-consuming method, requiring a great deal of paperwork. In addition, each lender had its own property and borrower standards, which further complicated transactions. More importantly, there was no system to obtain money from the capital markets. Lenders had to depend on deposits, which had proven to be volatile. The invention of the mortgage-backed security revolutionized the operation of the secondary market.

COLLATERALIZED MORTGAGE OBLIGATIONS

Fannie Mae issues mortgage-backed securities called Collateralized Mortgage Obligations (CMO). **COLLATERALIZED MORTGAGE OBLIGATIONS** were designed to limit prepayment risk to investors. Prior to this time, mortgage-backed securities were "passthroughs," which means that all the principal and interest collected were passed on to the investor. The investor had no protection from the early prepayment of principal.

When investors calculate yield, they make assumptions regarding the repayment of principal. When mortgages are paid early, the yield will change. Investors are seeking a security that can provide some protection against early prepayment.

A CMO is divided into classes. The first CMO had three classes called **TRANCHES**. Each class paid interest on the outstanding balance.

However, all collections of principal from the pool were first applied to class one. After that class had been paid in full, all principal collections went to class two. After class two had been paid in full, the remaining principal payments went to class three. The CMO gives investors opportunities to choose classes that offer different rates and maturities. The creation of the CMO attracted investors that were not normally mortgage investors.

An investor can select either a long-term tranche or a short-term tranche with or without pass-through privileges.

In 1986, Congress addressed this problem and created the Real Estate Mortgage Investment Conduit. A **REAL ESTATE MORTGAGE INVESTMENT CONDUIT (REMIC)** *is an entity that can issue CMO securities without double income taxation (only taxing individual investor).*

STANDARDIZATION OF FORMS

One major benefit brought of the creation of mortgage-backed securities by Freddie Mac and Fannie Mae is the standardization of conventional loan forms and property and borrower standards. FHA and DVA loans have been readily sold in the secondary market for years. One of the reasons is their standardized forms. As an investor you could buy an FHA or DVA loan anywhere in the United States and know the exact loan provisions. Previously this could not be done with a conventional loan.

To have a functional secondary market for conventional loans, standardization is necessary. Freddie Mac and Fannie Mae have accomplished this by using the same forms and by having essentially the same property and borrower standards. Almost all lenders today use the standard forms, and many adhere to the property and borrower standards set forth by the agencies. This gives the lenders confidence that their loans can be sold in the secondary market.

MORTGAGE REVENUE BONDS

The State of California and local governments have the authority to issue bonds. Interest paid on the bonds is tax exempt to the investors. *Bonds sold by state and local governments used to finance mortgages are called **Mortgage Revenue Bonds**.* Because the bonds are tax exempt, the interest rate is less than on a standard bond, and as a result, mortgage loans can be made at rates below market rate. The government agencies do not guarantee the bonds. The bonds are backed by the mortgages

created by the bond funds. The issuer of the bond merely acts as a conduit, and local lenders process, close, and then service the loans for the government. These bond issues generally work the same way as other mortgage-backed securities, but the paperwork is much more complex.

CHAPTER 7 QUIZ

1. A loan which is paid in full by equal periodic payments over the loan term is called:
 - A. Straight note
 - B. Fully amortized note
 - C. Partially amortized note
 - D. Negative amortized note
2. The entire principal is due in a lump sum at the end of the term of a (n):
 - A. Amortized loan
 - B. Straight note
 - C. Interest-only loan
 - D. Both B and C
3. A loan with a balloon payment is most likely to be:
 - A. Fully amortized
 - B. Partially amortized
 - C. Straight
 - D. Both A and B
4. The nominal rate of interest is:
 - A. Stated in a promissory note to the lender
 - B. 10 percent in California because the rate is set by law
 - C. Interest that is compounded daily
 - D. Also known as the legal rate as set by California law
5. All of the following participate in a national secondary market for real estate mortgages, **except**:
 - A. FDIC
 - B. FHLMC
 - C. GNMA
 - D. FNMA
6. The formula for interest calculations is:
 - A. $I = P \times R \times T$
 - B. $R = I / P \times T$
 - C. $T = I / P \times R$
 - D. All of the above

7. The objectives and mechanics of the secondary mortgage market are many and varied, including:
 - A. Making below-market interest rate loans to home buyers.
 - B. Buying and selling existing mortgages.
 - C. Providing funds for needy sellers.
 - D. Insuring loans for home buyers.
8. Which of the following is a major buyer and seller in the secondary mortgage market?
 - A. FHA
 - B. FNMA
 - C. DVA
 - D. Cal-Vet
9. In general, most monthly real estate loan payments are received by lenders:
 - A. On the 1st of the month
 - B. Between the 1st and 10th of the month
 - C. Between the 20th and 30th of the month
 - D. On the 30th of the month
10. Which of the following is also significantly involved in the secondary mortgage market?
 - A. Federal Reserve Board
 - B. Federal Housing Administration
 - C. California Housing Finance Agency
 - D. Federal Home Loan Mortgage Corporation

Chapter 7 Answers: 1-B, 2-D, 3-B, 4-A, 5-A, 6-A, 7-B, 8-B, 9-B, 10-D

CHAPTER 8: FINANCING INSTRUMENTS



PREVIEW

Like other professionals, real estate lenders use a variety of financing instruments to complete a real estate loan. In California, the major instruments of real estate finance are the promissory note, the deed of trust, and, to a lesser extent, the installment sales contract. In this chapter we will talk about these mortgage instruments, the meaning of voluntary money encumbrances (liens) their effects of security, and the various loan clauses that are used in the mortgage instruments.

FINANCING INSTRUMENTS

Real estate loans in California generally are made using two instruments, promissory notes and security instruments. A **PROMISSORY NOTE** is evidence of the underlying obligation of the loan transaction. **SECURITY INSTRUMENTS** (trust deed or mortgage or land contract) are financing instruments used to identify the real estate that serves as assurance that the loan will be repaid. Usually, borrowers hypothecate their real property as security for payment of the promissory note.

PROMISSORY NOTE

When money is borrowed to purchase real estate, the borrower agrees to repay the loan by signing a *promissory note*, which outlines the terms of repayment and sets the due date. The promissory note is legal evidence that a debt is owed. The two most common types of promissory notes in general use are the **straight note** and the **amortized note/installment note**.

☞ *The straight note is an interest-only note.*

Under a straight note, the borrower agrees to pay the interest periodically (or all at one time, when the note matures) and to pay the entire principal in a lump sum on the due date.

The second type of real estate promissory note, and by far the most common, is the *installment note*. An *installment note* requires periodic payments that include both **principal and interest**. This reduction in principal is referred to as **amortization**.

CHARACTERISTICS OF PROMISSORY NOTE

Whether a debt is secured by real property, personal property, or has no security at all, the promissory note is the legal, enforceable promise to pay back the money borrowed. It is the "**evidence of the debt**."

Promissory notes are called "**two-party paper**." The *maker* of a note promises to pay the *holder* of the note a specified sum of money according to the terms stated on the note.

Payor - The maker of the note; the one who pays; the borrower.

Payee - The holder of the note; the receiver of the money payable under the note; the lender.

NEGOTIABLE NOTES

These are notes freely transferable in commerce. When properly prepared, they are typically accepted as the equivalent of cash. To be considered a negotiable note, the instrument must conform to statutory requirements, including:

- An unconditional promise to pay
- In writing
- Made by one person to another and signed by the maker
- Payable upon demand or on a fixed date
- For a specific sum of money
- Payable either "to the order of" or "to the bearer"

All of these elements must be present if the instrument is to qualify as a negotiable note.

ENDORSEMENT OF NOTES

If a note is payable "**to bearer**," endorsement is unnecessary since the note is transferred by simple delivery to the other person. Paper money is such a note. If the note is payable to a named person, that person must

"order" the maker to pay to the transferee by an endorsement. The endorsement may be:

- ♦ **In Blank** - Endorsement with a signature alone makes the note payable to any bearer of the note.
- ♦ **Special** - Holder endorses "pay to the order of (name of new payee)" and signs the note; the note is now payable only to the new payee.
- ♦ **Restrictive** - Holder restricts further negotiability by writing "for deposit only" and signs the note.
- ♦ **Qualified** - Adding the words "without recourse" before signing a note means the endorser will not be liable for the amount of the note if the maker refuses to pay.

HOLDER IN DUE COURSE

One who takes a negotiable note which has been transferred from the original payee through endorsement becomes a holder in due course, with certain rights, under the following conditions:

- ♦ **Valid Note** - Note is valid on its face.
- ♦ **Innocent of Defects** - Holder became the holder of the note without knowledge of any defects (if such exist.)
- ♦ **Good Faith and Consideration** - Holder took the note in good faith and for a valuable consideration.

DEFENSES BY THE MAKER

Under certain circumstances the maker of the note cannot be held to the promise to pay. Some circumstances affect the debt only as against the original payee; others any subsequent holder.

- ♦ **Personal Defenses** - The maker may use the following commonly recognized personal defenses against the original payee, but *not* against a holder in due course.
 - Fraud in inducement, e.g., false statements used by the payee to procure the signing of the note.
 - Lack of valuable consideration from the payee to the maker.
 - Prior payment or cancellation.

- If payee owed maker an amount of money on another obligation, the current negotiable note is not a "set-off" once it has been transferred to a holder in due course.
- ♦ **Real Defenses** - These are defenses allowed against anyone, even a holder in due course. They result from major defects in the validity of the contract or document.
 - Incapacity of the maker.
 - Illegality of the instrument, such as a note used in connection with illegal conduct
 - Forged document.
 - Material alteration (holder in due course may collect on original legal terms of the note.)

Form 8-1: Promissory Note (Sample Form, Page 1)

PROMISSORY NOTE

Date: _____

For value received, the undersigned _____ (the "Borrower"), at _____,
promises to pay to the order of _____ (the "Lender"), at _____,
_____ (or at such other place as
the Lender may designate in writing), the sum of \$0.00 with no interest.

I. TERMS OF REPAYMENT

A. Payments

Unpaid principal after the Due Date shown below shall accrue interest at a rate of 0% annually until paid.

The unpaid principal shall be payable in monthly installments of \$0.00, beginning on _____, and ending April 15, 2016, (the "Due Date") at which time the remaining unpaid balance of the Note shall be due in full.

B. Application of Payments

All payments on this Note shall be applied first in payment of accrued interest and any remainder in payment of principal.

C. Late Fee

The Borrower promises to pay a late charge of \$0.00 for each installment that remains unpaid more than _____ day(s) after its Due Date. This late charge shall be paid as liquidated damages in lieu of actual damages, and not as a penalty. Payment of such late charge shall, under no circumstances, be construed to cure any default arising from or relating to such late payment.

D. Acceleration of Debt

If any payment obligation under this Note is not paid when due, the remaining unpaid principal balance and any accrued interest shall become due immediately at the option of the Lender.

II. PREPAYMENT

The Borrower reserves the right to prepay this Note (in whole or in part) prior to the Due Date

MORTGAGES AND TRUST DEEDS

Mortgages and trust deeds are liens, or charges upon a property, by which property or title has been made the security for repayment of money by the borrower. The term "mortgage" is commonly used with two different meanings. In its generic meaning, the word mortgage is used to describe any device used for the pledging of property to a creditor as security for the payment of a debt. In that sense, it is correct to say that in California we usually use the deed of trust as our form of mortgage. In California we have "mortgage companies," not "trust deed companies." On the other hand, a standard mortgage contract is technically quite different from a trust deed and is rarely used in California, although it is still used in a majority of the states.

We will look at mortgages and trust deeds as distinctly different instruments, although both have the same purpose as security devices.

HYPOTHECATION

To ***HYPOTHECATE*** is to give title of a property as security for a loan without the necessity of giving up possession or use of the property. This principle is fundamental to the major instruments of real estate finance, i.e., the trust deed in California and the less common mortgage. Each of these instruments uses the promissory note as the primary evidence of debt, which creates a lien on the property.

MORTGAGE CONTRACT

A mortgage contract is a written contract by which title to property is hypothecated (promised without giving up possession) to secure repayment of money borrowed. The borrower retains both title and possession.

CHARACTERISTICS OF MORTGAGE CONTRACT:

- ♦ **Parties** - A mortgage contract has two parties, the mortgagor and the mortgagee.
 - **Mortgagor** - Owner or buyer (borrower), who gives a mortgage as security to the mortgagee.
 - **Mortgagee** - Lender or seller, who receives a mortgage from the mortgagor as security for repayment of a
- ♦ **Recording** - Recording establishes priority by giving constructive notice "to the world" of the contents of a document. For a mortgage to be recordable, it must be acknowledged by the

mortgagor (usually in the presence of a notary public who receives the acknowledgment.)

- ♦ **Release** - Upon payment in full, the mortgagor is given a "satisfaction of mortgage." Upon recording, this releases the title from the lien.

FORECLOSURE

By Superior Court action, a mortgagee may foreclose within four years of delinquency or maturity of the mortgage contract. Foreclosure is by "judicial sale." The steps involved are:

- ♦ Complaint is filed.
- ♦ Trial is held.
- ♦ Court issues a decree of foreclosure and an order of sale.
- ♦ Sheriff or court commissioner auctions property after legal notice has been posted and published.
- ♦ Property is sold to the highest bidder at sale.
- ♦ Buyer at sale is issued a "**certificate of sale**," but does not receive immediate title or possession.
 - If a deficiency judgment is possible, the property is sold subject to the "right of redemption." The mortgagor may have a **three-month right of redemption** (or "*equity rights of redemption*") if the sale proceeds are sufficient to pay the secured indebtedness plus interest and costs of foreclosure, or a **one year right of redemption** (or "*statutory rights of redemption*") if the sale proceeds are not sufficient to satisfy the secured indebtedness with interest and costs of action and of sale.
 - Mortgagor may remain in possession during "redemption period," which could be up to one year.
- ♦ At the end of the redemption period, a "sheriff's deed" is issued to the new owner of title.

POWER OF SALE CLAUSE

This clause in a mortgage makes foreclosure out of court possible, using the same procedures as a trustee's sale under a trust deed (non-judicial

sale.) Power of sale clause will be discussed in detail in this chapter under Loan Clauses.

DEFICIENCY JUDGMENT

If the sale proceeds do not fully satisfy the debts secured by the mortgage, a deficiency judgment may be granted by the court against the debtor.

However, deficiency judgments are prohibited on a:

- ♦ Mortgage given to seller for all or part of the purchase price.
- ♦ Mortgage given to a lender to finance purchase of an owner-occupied dwelling of four or less units.

TRUST DEED

In real estate financing in California and some other states, a deed of trust is generally used along with a promissory note (evidence of debt) as a security device. It creates a lien on the property when recorded. A trust deed is a security device which is both a contract and a conveyance, pledging property as a guarantee for repayment of a debt. "**Bare legal title**" is conveyed by a trustor to a trustee for the lender's benefit. In case of default, the trustee has the power to foreclose out of court at the request of the beneficiary.

CHARACTERISTICS OF TRUST DEED

Parties - In addition to the borrower and lender, the trust deed involves a third party, the trustee.

- **Trustor** - The borrower. The owner or buyer who deeds bare legal title of property securing the loan to a trustee to be held as security until the trustor has performed the obligation to the lender under the terms of the deed of trust
- **Beneficiary** - The lender. The holder of the promissory note and of the trust deed guaranteeing repayment. Benefits from the "trust."
- **Trustee** - A neutral third party. Holder, in trust, of the "bare legal title" with the power of sale described above.

Effect of Title - Bare (or naked) Legal Title is transferred by the trust deed to a trustee (intermediary between trustor and beneficiary) who has "power of sale" in the event of default by the trustor. Equitable title remains with the trustor, who can also give a junior trust deed (or deeds).

Recordation - Recording of the trust deed is permitted and recommended, since it establishes priority. Recording is not required to make a trust deed effective.

Short Form - So that only the front page of a trust deed need be recorded, most trust deeds are written as a "Short Form Deed of Trust and Assignment of Rents," which makes reference to information contained on the reverse side which has been previously recorded in the same county.

Fictitious Deed of Trust - This is a device used to put all standard provisions of any given lender or title company, etc., on the public record *in any county* in which the *firm does business*. It is "fictitious" in the sense that it does not cite a specific property.

Only the front side of subsequent "actual" trust deeds need be recorded, showing names, property data, and other variables. The borrower agrees to all of the terms printed on the back of the trust deed, terms recorded in the earlier fictitious deed of trust. This procedure saves in fees, records space, and unnecessary duplication.

The reverse side of the actual trust deed contains a reprint of the standard provisions, for easy reference by the trustor or others.

Priority - The earliest recording date makes it a first trust deed, unless it contains a ***subordination clause***, by which the beneficiary agrees to move to a junior position if another trust deed (usually a construction loan) is recorded at a later date.

RELATION OF TRUST DEED TO NOTE

The lien of a trust deed or mortgage used as a security device to assure the payment of debt, by using title to real property as security, is a mere incident of the debt. Without the debt, there is no lien.

Validity - if the note is unenforceable, the mortgage or trust deed gives it no validity.

Obligation - The note and the mortgage or trust deed are to be construed together. A clause in either obligates the other.

Conflict in Terms - If any conflict exists between the provisions of the note and the mortgage or trust deed, the note will take priority.

Assignment - In case of assignment, the note and the security device (mortgage or trust deed) must go together. They cannot be assigned independently.

Release -The lien is released by reconveyance of the title from the trustee to the trustor by the recording of a deed of reconveyance.

Request for Reconveyance - When the obligation secured by any deed of trust has been satisfied, the beneficiary must deliver to the trustee the original note, the deed of trust, and a request for full reconveyance.

DEED OF RECONVEYANCE

The trustee must record a deed of reconveyance within 21 calendar days after receipt of the request for reconveyance and appropriate fees.

60 Day limit - If the trustee has failed to record the reconveyance within 60 calendar days of the satisfaction of the obligation, the beneficiary, upon written request by the trustor, shall substitute itself or another trustee and issue a full reconveyance.

75 Day limit - If a full reconveyance has not been recorded within 75 calendar days of satisfaction, then a title insurance company may prepare and record a release of the obligation, which release will be equivalent to a reconveyance of title.

Violations - Any violator of these requirements shall be liable for actual damages plus \$300. In addition, any person who willfully violates this law is guilty of a misdemeanor, punishable by a fine up to \$400 and/or imprisonment in the county jail for up to six months.

FORECLOSURE BY TRUSTEE'S SALE

One reason for the popularity of trust deeds with lenders is the availability of a non-judicial foreclosure procedure.

NOTICE OF DEFAULT

The beneficiary notifies the trustee of default, then notifies the trustor and records the "notice of default." The trustee is also obligated to provide notices to all other lien holders of record and to anyone who has recorded a request for notice of default.

REDEMPTION PERIOD

The trustee must wait a minimum of three months, during which the trustor may avoid sale in various ways.

- ♦ The trustor may reinstate the loan by making delinquent payments and penalties up to within 5 days of the sale.

- ♦ The trustor may give a "deed in lieu of foreclosure" to satisfy the lien, if the lien holder is willing. The lien holder takes title subject to all other existing liens. This procedure protects the borrower's credit and avoids foreclosure costs.
- ♦ The trustor may pay the entire balance.

NOTICE OF SALE

The trustee publishes a "**notice of sale**" once a week for 21 days and posts notice on property. In addition, the notice of sale must be recorded in the county where the property is located at least 14 days prior to the sale. Sale date is usually 22 or 23 days after notice.

- ♦ The notice must include a description of the property or, if none is available, the name and address of the beneficiary.
- ♦ The trustor may still pay off the full loan and penalties prior to the sale; no redemption right exists after the sale.

TRUSTEE'S AUCTION

The trustee sells to the highest bidder, pays expenses and lien(s), and issues a trustee's deed.

- ♦ Title is cleared of all junior liens except possible mechanic's liens or real estate tax liens.
- ♦ No deficiency judgment is allowed following a trustee's sale. However, a foreclosing beneficiary at a trustee's sale may later sue for damages and pursue post-sale claims against the trustor for bad faith waste and fraud. To do so the beneficiary must have made a credit bid at the trustee's auction that was less than the amount of the secured debt and foreclosure costs.

FORECLOSURE TIME

The foreclosure process under a trust deed is relatively speedy compared to the court proceedings under a mortgage.

- ♦ "Notice of default" - 3 months minimum plus additional time which may be granted.
- ♦ "Notice of sale" -21 days.
- ♦ Total time to accomplish foreclosure - approximately 4 months.

TRUSTOR'S RIGHT OF REINSTATEMENT

A debt under a trust deed can be reinstated by a trustor if payment of the overdue amount is made at any time after the notice of default is recorded, but no later than **five (5) business days** prior to the date of sale in the subsequent recorded **notice of sale**.

Reinstatement within the five-day period preceding the sale would be at the discretion of the beneficiary and might still be allowed.

Figure 8-1 Trustee's Sale Timetable

TRUSTEE'S SALE TIMETABLE

10-15 Days Notice of Default	3 Months Reinstatement Period (Waiting Period)	21 Days Notice of Publishing	1 Day Trustee's Sale

FORECLOSURE BY COURT (JUDICIAL)

The method of foreclosing on a trust deed is the choice of the beneficiary. Court action could be chosen to gain the opportunity for a deficiency judgment.

Procedure - The procedure becomes the same as for a mortgage.

Form 8-2: Deed of Trust

After Recording Return To:

[Space Above This Line For Recording Data]_____

DEED OF TRUST

DEFINITIONS

Words used in multiple sections of this document are defined below and other words are defined in Sections 3, 11, 13, 18, 20 and 21. Certain rules regarding the usage of words used in this document are also provided in Section 16.

(A)"Security Instrument" means this document, which is dated _____, _____, together with all Riders to this document.

(B)"Borrower" _____ is _____.

Borrower is the trustor under this Security Instrument.

(C)"Lender" _____ is _____.

Lender is a _____ organized and existing under the laws of _____.
Lender's address is _____.

Lender is the beneficiary under this Security Instrument.

(D)"Trustee" _____ is _____.

(E)"Note" means the promissory note signed by Borrower and dated _____, _____. The Note states that Borrower owes Lender

_____ Dollars (U.S. \$_____) plus interest. Borrower has promised to pay this debt in regular Periodic Payments and to pay the debt in full not later than _____.

(F)"Property" means the property that is described below under the heading "Transfer of Rights in the Property."

(G)"Loan" means the debt evidenced by the Note, plus interest, any prepayment charges and late charges due under the Note, and all sums due under this Security Instrument, plus interest.

(H)"Riders" means all Riders to this Security Instrument that are executed by Borrower. The following Riders are to be executed by Borrower [check box as applicable]:

☐Adjustable Rate Rider ☐Condominium Rider ☐Second Home Rider
☐Balloon Rider ☐Planned Unit Development Rider ☐Other(s) [specify]

☐1-4 Family Rider ☐Biweekly Payment Rider

(I)"Applicable Law" means all controlling applicable federal, state and local statutes, regulations, ordinances and administrative rules and orders (that have the effect of law) as well as all applicable final, non-appealable judicial opinions.

(J)"Community Association Dues, Fees, and Assessments" means all dues, fees, assessments and other charges that are imposed on Borrower or the Property by a condominium association, homeowners association or similar organization.

(K)"Electronic Funds Transfer" means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, computer, or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, transfers initiated by telephone, wire transfers, and automated clearinghouse transfers.

(L)"Escrow Items" means those items that are described in Section 3.

(M)"Miscellaneous Proceeds" means any compensation, settlement, award of damages, or proceeds paid by any third party (other than insurance proceeds paid under the coverages described in Section 5) for: (i) damage to, or destruction of, the Property; (ii) condemnation or other taking of all or any part of the Property; (iii) conveyance in lieu of condemnation; or (iv) misrepresentations of, or omissions as to, the value and/or condition of the Property.

(N)"Mortgage Insurance" means insurance protecting Lender against the nonpayment of, or default on, the Loan.

(O)"Periodic Payment" means the regularly scheduled amount due for (i) principal and interest under the Note, plus (ii) any amounts under Section 3 of this Security Instrument.

(P)"RESPA" means the Real Estate Settlement Procedures Act (12 U.S.C. §2601 et seq.) and its implementing regulation, Regulation X (24 C.F.R. Part 3500), as they might be amended from time to time, or any additional or successor legislation or regulation that governs the same subject matter. As used in this Security Instrument, "RESPA" refers to all requirements and restrictions that are imposed in regard to a "federally related mortgage loan" even if the Loan does not qualify as a "federally related mortgage loan" under RESPA.

(Q)"Successor in Interest of Borrower" means any party that has taken title to the Property, whether or not that party has assumed Borrower's obligations under the Note and/or this Security Instrument.

TRANSFER OF RIGHTS IN THE PROPERTY

This Security Instrument secures to Lender: (i) the repayment of the Loan, and all renewals, extensions and modifications of the Note; and (ii) the performance of Borrower's covenants and agreements under this Security Instrument and the Note. For this purpose, Borrower irrevocably grants and conveys to Trustee, in trust, with power of sale, the following described property located in the _____ of _____:
[Type of Recording Jurisdiction][Name of Recording Jurisdiction]

which currently has the address of

[Street] ("Property Address"):
_____, California _____
[City][Zip Code]

TOGETHER WITH all the improvements now or hereafter erected on the property, and all easements, appurtenances, and fixtures now or hereafter a part of the property. All replacements and additions shall also be covered by this Security Instrument. All of the foregoing is referred to in this Security Instrument as the "Property."

BORROWER COVENANTS that Borrower is lawfully seised of the estate hereby conveyed and has the right to grant and convey the Property and that the Property is unencumbered, except for encumbrances of record. Borrower warrants and will defend generally the title to the Property against all claims and demands, subject to any encumbrances of record.

THIS SECURITY INSTRUMENT combines uniform covenants for national use and non-uniform covenants with limited variations by jurisdiction to constitute a uniform security instrument covering real property.

UNIFORM COVENANTS. Borrower and Lender covenant and agree as follows:

1.Payment of Principal, Interest, Escrow Items, Prepayment Charges, and Late Charges. Borrower shall pay when due the principal of, and interest on, the debt evidenced by the Note and any prepayment charges and late charges due under the Note. Borrower shall also pay funds for Escrow Items pursuant to Section 3. Payments due under the

Note and this Security Instrument shall be made in U.S. currency. However, if any check or other instrument received by Lender as payment under the Note or this Security Instrument is returned to Lender unpaid, Lender may require that any or all subsequent payments due under the Note and this Security Instrument be made in one or more of the following forms, as selected by Lender: (a) cash; (b) money order; (c) certified check, bank check, treasurer's check or cashier's check, provided any such check is drawn upon an institution whose deposits are insured by a federal agency, instrumentality, or entity; or (d) Electronic Funds Transfer.

Payments are deemed received by Lender when received at the location designated in the Note or at such other location as may be designated by Lender in accordance with the notice provisions in Section 15. Lender may return any payment or partial payment if the payment or partial payments are insufficient to bring the Loan current. Lender may accept any payment or partial payment insufficient to bring the Loan current, without waiver of any rights hereunder or prejudice to its rights to refuse such payment or partial payments in the future, but Lender is not obligated to apply such payments at the time such payments are accepted. If each Periodic Payment is applied as of its scheduled due date, then Lender need not pay interest on unapplied funds. Lender may hold such unapplied funds until Borrower makes payment to bring the Loan current. If Borrower does not do so within a reasonable period of time, Lender shall either apply such funds or return them to Borrower. If not applied earlier, such funds will be applied to the outstanding principal balance under the Note immediately prior to foreclosure. No offset or claim which Borrower might have now or in the future against Lender shall relieve Borrower from making payments due under the Note and this Security Instrument or performing the covenants and agreements secured by this Security Instrument.

2.Application of Payments or Proceeds. Except as otherwise described in this Section 2, all payments accepted and applied by Lender shall be applied in the following order of priority: (a) interest due under the Note; (b) principal due under the Note; (c) amounts due under Section 3. Such payments shall be applied to each Periodic Payment in the order in which it became due. Any remaining amounts shall be applied first to late charges, second to any other amounts due under this Security Instrument, and then to reduce the principal balance of the Note. If Lender receives a payment from Borrower for a delinquent Periodic Payment which includes a sufficient amount to pay any late charge due, the payment may be applied to the delinquent payment and the late charge. If more than one Periodic Payment is outstanding, Lender may apply any payment received from Borrower to the repayment of the Periodic Payments if, and to the extent that, each payment can be paid in

full. To the extent that any excess exists after the payment is applied to the full payment of one or more Periodic Payments, such excess may be applied to any late charges due. Voluntary prepayments shall be applied first to any prepayment charges and then as described in the Note.

Any application of payments, insurance proceeds, or Miscellaneous Proceeds to principal due under the Note shall not extend or postpone the due date, or change the amount, of the Periodic Payments.

3.Funds for Escrow Items. Borrower shall pay to Lender on the day Periodic Payments are due under the Note, until the Note is paid in full, a sum (the "Funds") to provide for payment of amounts due for: (a) taxes and assessments and other items which can attain priority over this Security Instrument as a lien or encumbrance on the Property; (b) leasehold payments or ground rents on the Property, if any; (c) premiums for any and all insurance required by Lender under Section 5; and (d) Mortgage Insurance premiums, if any, or any sums payable by Borrower to Lender in lieu of the payment of Mortgage Insurance premiums in accordance with the provisions of Section 10. These items are called "Escrow Items." At origination or at any time during the term of the Loan, Lender may require that Community Association Dues, Fees, and Assessments, if any, be escrowed by Borrower, and such dues, fees and assessments shall be an Escrow Item. Borrower shall promptly furnish to Lender all notices of amounts to be paid under this Section. Borrower shall pay Lender the Funds for Escrow Items unless Lender waives Borrower's obligation to pay the Funds for any or all Escrow Items. Lender may waive Borrower's obligation to pay to Lender Funds for any or all Escrow Items at any time. Any such waiver may only be in writing. In the event of such waiver, Borrower shall pay directly, when and where payable, the amounts due for any Escrow Items for which payment of Funds has been waived by Lender and, if Lender requires, shall furnish to Lender receipts evidencing such payment within such time period as Lender may require. Borrower's obligation to make such payments and to provide receipts shall for all purposes be deemed to be a covenant and agreement contained in this Security Instrument, as the phrase "covenant and agreement" is used in Section 9. If Borrower is obligated to pay Escrow Items directly, pursuant to a waiver, and Borrower fails to pay the amount due for an Escrow Item, Lender may exercise its rights under Section 9 and pay such amount and Borrower shall then be obligated under Section 9 to repay to Lender any such amount. Lender may revoke the waiver as to any or all Escrow Items at any time by a notice given in accordance with Section 15 and, upon such revocation, Borrower shall pay to Lender all Funds, and in such amounts, that are then required under this Section 3.

Lender may, at any time, collect and hold Funds in an amount (a) sufficient to permit Lender to apply the Funds at the time specified under

RESPA, and (b) not to exceed the maximum amount a lender can require under RESPA. Lender shall estimate the amount of Funds due on the basis of current data and reasonable estimates of expenditures of future Escrow Items or otherwise in accordance with Applicable Law.

The Funds shall be held in an institution whose deposits are insured by a federal agency, instrumentality, or entity (including Lender, if Lender is an institution whose deposits are so insured) or in any Federal Home Loan Bank. Lender shall apply the Funds to pay the Escrow Items no later than the time specified under RESPA. Lender shall not charge Borrower for holding and applying the Funds, annually analyzing the escrow account, or verifying the Escrow Items, unless Lender pays Borrower interest on the Funds and Applicable Law permits Lender to make such a charge. Unless an agreement is made in writing or Applicable Law requires interest to be paid on the Funds, Lender shall not be required to pay Borrower any interest or earnings on the Funds. Borrower and Lender can agree in writing, however, that interest shall be paid on the Funds. Lender shall give to Borrower, without charge, an annual accounting of the Funds as required by RESPA.

If there is a surplus of Funds held in escrow, as defined under RESPA, Lender shall account to Borrower for the excess funds in accordance with RESPA. If there is a shortage of Funds held in escrow, as defined under RESPA, Lender shall notify Borrower as required by RESPA, and Borrower shall pay to Lender the amount necessary to make up the shortage in accordance with RESPA, but in no more than 12 monthly payments. If there is a deficiency of Funds held in escrow, as defined under RESPA, Lender shall notify Borrower as required by RESPA, and Borrower shall pay to Lender the amount necessary to make up the deficiency in accordance with RESPA, but in no more than 12 monthly payments.

Upon payment in full of all sums secured by this Security Instrument, Lender shall promptly refund to Borrower any Funds held by Lender.

4.Charges; Liens. Borrower shall pay all taxes, assessments, charges, fines, and impositions attributable to the Property which can attain priority over this Security Instrument, leasehold payments or ground rents on the Property, if any, and Community Association Dues, Fees, and Assessments, if any. To the extent that these items are Escrow Items, Borrower shall pay them in the manner provided in Section 3.

Borrower shall promptly discharge any lien which has priority over this Security Instrument unless Borrower: (a) agrees in writing to the payment of the obligation secured by the lien in a manner acceptable to Lender, but only so long as Borrower is performing such agreement; (b) contests the lien in good faith by, or defends against enforcement of the lien in, legal proceedings which in Lender's opinion operate to prevent the enforcement of the lien while those proceedings are pending, but only until such proceedings are concluded; or (c) secures from the holder of

the lien an agreement satisfactory to Lender subordinating the lien to this Security Instrument. If Lender determines that any part of the Property is subject to a lien which can attain priority over this Security Instrument, Lender may give Borrower a notice identifying the lien. Within 10 days of the date on which that notice is given, Borrower shall satisfy the lien or take one or more of the actions set forth above in this Section 4.

Lender may require Borrower to pay a one-time charge for a real estate tax verification and/or reporting service used by Lender in connection with this Loan.

5. Property Insurance. Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term "extended coverage," and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance. This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires. What Lender requires pursuant to the preceding sentences can change during the term of the Loan. The insurance carrier providing the insurance shall be chosen by Borrower subject to Lender's right to disapprove Borrower's choice, which right shall not be exercised unreasonably. Lender may require Borrower to pay, in connection with this Loan, either: (a) a one-time charge for flood zone determination, certification and tracking services; or (b) a one-time charge for flood zone determination and certification services and subsequent charges each time remappings or similar changes occur which reasonably might affect such determination or certification. Borrower shall also be responsible for the payment of any fees imposed by the Federal Emergency Management Agency in connection with the review of any flood zone determination resulting from an objection by Borrower.

If Borrower fails to maintain any of the coverages described above, Lender may obtain insurance coverage, at Lender's option and Borrower's expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage shall cover Lender, but might or might not protect Borrower, Borrower's equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was previously in effect. Borrower acknowledges that the cost of the insurance coverage so obtained might significantly exceed the cost of insurance that Borrower could have obtained. Any amounts disbursed by Lender under this Section 5 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment.

All insurance policies required by Lender and renewals of such policies shall be subject to Lender's right to disapprove such policies, shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee and Borrower further agrees to generally assign rights to insurance proceeds to the holder of the Note up to the amount of the outstanding loan balance. Lender shall have the right to hold the policies and renewal certificates. If Lender requires, Borrower shall promptly give to Lender all receipts of paid premiums and renewal notices. If Borrower obtains any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy shall include a standard mortgage clause and shall name Lender as mortgagee and/or as an additional loss payee and Borrower further agrees to generally assign rights to insurance proceeds to the holder of the Note up to the amount of the outstanding loan balance.

In the event of loss, Borrower shall give prompt notice to the insurance carrier and Lender. Lender may make proof of loss if not made promptly by Borrower. Unless Lender and Borrower otherwise agree in writing, any insurance proceeds, whether or not the underlying insurance was required by Lender, shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened. During such repair and restoration period, Lender shall have the right to hold such insurance proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such insurance proceeds, Lender shall not be required to pay Borrower any interest or earnings on such proceeds. Fees for public adjusters, or other third parties, retained by Borrower shall not be paid out of the insurance proceeds and shall be the sole obligation of Borrower. If the restoration or repair is not economically feasible or Lender's security would be lessened, the insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such insurance proceeds shall be applied in the order provided for in Section 2.

If Borrower abandons the Property, Lender may file, negotiate and settle any available insurance claim and related matters. If Borrower does not respond within 30 days to a notice from Lender that the insurance carrier has offered to settle a claim, then Lender may negotiate and settle the claim. The 30-day period will begin when the notice is given. In either event, or if Lender acquires the Property under Section 22 or otherwise,

Borrower hereby assigns to Lender (a) Borrower's rights to any insurance proceeds in an amount not to exceed the amounts unpaid under the Note or this Security Instrument, and (b) any other of Borrower's rights (other than the right to any refund of unearned premiums paid by Borrower) under all insurance policies covering the Property, insofar as such rights are applicable to the coverage of the Property. Lender may use the insurance proceeds either to repair or restore the Property or to pay amounts unpaid under the Note or this Security Instrument, whether or not then due.

6.Occupancy. Borrower shall occupy, establish, and use the Property as Borrower's principal residence within 60 days after the execution of this Security Instrument and shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender otherwise agrees in writing, which consent shall not be unreasonably withheld, or unless extenuating circumstances exist which are beyond Borrower's control.

7.Preservation, Maintenance and Protection of the Property; Inspections. Borrower shall not destroy, damage or impair the Property, allow the Property to deteriorate or commit waste on the Property. Whether or not Borrower is residing in the Property, Borrower shall maintain the Property in order to prevent the Property from deteriorating or decreasing in value due to its condition. Unless it is determined pursuant to Section 5 that repair or restoration is not economically feasible, Borrower shall promptly repair the Property if damaged to avoid further deterioration or damage. If insurance or condemnation proceeds are paid in connection with damage to, or the taking of, the Property, Borrower shall be responsible for repairing or restoring the Property only if Lender has released proceeds for such purposes. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed. If the insurance or condemnation proceeds are not sufficient to repair or restore the Property, Borrower is not relieved of Borrower's obligation for the completion of such repair or restoration.

Lender or its agent may make reasonable entries upon and inspections of the Property. If it has reasonable cause, Lender may inspect the interior of the improvements on the Property. Lender shall give Borrower notice at the time of or prior to such an interior inspection specifying such reasonable cause.

8.Borrower's Loan Application. Borrower shall be in default if, during the Loan application process, Borrower or any persons or entities acting at the direction of Borrower or with Borrower's knowledge or consent gave materially false, misleading, or inaccurate information or statements to Lender (or failed to provide Lender with material information) in

connection with the Loan. Material representations include, but are not limited to, representations concerning Borrower's occupancy of the Property as Borrower's principal residence.

9. Protection of Lender's Interest in the Property and Rights Under this Security Instrument. If (a) Borrower fails to perform the covenants and agreements contained in this Security Instrument, (b) there is a legal proceeding that might significantly affect Lender's interest in the Property and/or rights under this Security Instrument (such as a proceeding in bankruptcy, probate, for condemnation or forfeiture, for enforcement of a lien which may attain priority over this Security Instrument or to enforce laws or regulations), or (c) Borrower has abandoned the Property, then Lender may do and pay for whatever is reasonable or appropriate to protect Lender's interest in the Property and rights under this Security Instrument, including protecting and/or assessing the value of the Property, and securing and/or repairing the Property. Lender's actions can include, but are not limited to: (a) paying any sums secured by a lien which has priority over this Security Instrument; (b) appearing in court; and (c) paying reasonable attorneys' fees to protect its interest in the Property and/or rights under this Security Instrument, including its secured position in a bankruptcy proceeding. Securing the Property includes, but is not limited to, entering the Property to make repairs, change locks, replace or board up doors and windows, drain water from pipes, eliminate building or other code violations or dangerous conditions, and have utilities turned on or off. Although Lender may take action under this Section 9, Lender does not have to do so and is not under any duty or obligation to do so. It is agreed that Lender incurs no liability for not taking any or all actions authorized under this Section 9.

Any amounts disbursed by Lender under this Section 9 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment.

If this Security Instrument is on a leasehold, Borrower shall comply with all the provisions of the lease. If Borrower acquires fee title to the Property, the leasehold and the fee title shall not merge unless Lender agrees to the merger in writing.

10. Mortgage Insurance. If Lender required Mortgage Insurance as a condition of making the Loan, Borrower shall pay the premiums required to maintain the Mortgage Insurance in effect. If, for any reason, the Mortgage Insurance coverage required by Lender ceases to be available from the mortgage insurer that previously provided such insurance and Borrower was required to make separately designated payments toward

the premiums for Mortgage Insurance, Borrower shall pay the premiums required to obtain coverage substantially equivalent to the Mortgage Insurance previously in effect, at a cost substantially equivalent to the cost to Borrower of the Mortgage Insurance previously in effect, from an alternate mortgage insurer selected by Lender. If substantially equivalent Mortgage Insurance coverage is not available, Borrower shall continue to pay to Lender the amount of the separately designated payments that were due when the insurance coverage ceased to be in effect. Lender will accept, use and retain these payments as a non-refundable loss reserve in lieu of Mortgage Insurance. Such loss reserve shall be non-refundable, notwithstanding the fact that the Loan is ultimately paid in full, and Lender shall not be required to pay Borrower any interest or earnings on such loss reserve. Lender can no longer require loss reserve payments if Mortgage Insurance coverage (in the amount and for the period that Lender requires) provided by an insurer selected by Lender again becomes available, is obtained, and Lender requires separately designated payments toward the premiums for Mortgage Insurance. If Lender required Mortgage Insurance as a condition of making the Loan and Borrower was required to make separately designated payments toward the premiums for Mortgage Insurance, Borrower shall pay the premiums required to maintain Mortgage Insurance in effect, or to provide a non-refundable loss reserve, until Lender's requirement for Mortgage Insurance ends in accordance with any written agreement between Borrower and Lender providing for such termination or until termination is required by Applicable Law. Nothing in this Section 10 affects Borrower's obligation to pay interest at the rate provided in the Note.

Mortgage Insurance reimburses Lender (or any entity that purchases the Note) for certain losses it may incur if Borrower does not repay the Loan as agreed. Borrower is not a party to the Mortgage Insurance.

Mortgage insurers evaluate their total risk on all such insurance in force from time to time, and may enter into agreements with other parties that share or modify their risk, or reduce losses. These agreements are on terms and conditions that are satisfactory to the mortgage insurer and the other party (or parties) to these agreements. These agreements may require the mortgage insurer to make payments using any source of funds that the mortgage insurer may have available (which may include funds obtained from Mortgage Insurance premiums).

As a result of these agreements, Lender, any purchaser of the Note, another insurer, any reinsurer, any other entity, or any affiliate of any of the foregoing, may receive (directly or indirectly) amounts that derive from (or might be characterized as) a portion of Borrower's payments for Mortgage Insurance, in exchange for sharing or modifying the mortgage

insurer's risk, or reducing losses. If such agreement provides that an affiliate of Lender takes a share of the insurer's risk in exchange for a share of the premiums paid to the insurer, the arrangement is often termed "captive reinsurance." Further:

(a) Any such agreements will not affect the amounts that Borrower has agreed to pay for Mortgage Insurance, or any other terms of the Loan. Such agreements will not increase the amount Borrower will owe for Mortgage Insurance, and they will not entitle Borrower to any refund.

(b) Any such agreements will not affect the rights Borrower has - if any - with respect to the Mortgage Insurance under the Homeowners Protection Act of 1998 or any other law. These rights may include the right to receive certain disclosures, to request and obtain cancellation of the Mortgage Insurance, to have the Mortgage Insurance terminated automatically, and/or to receive a refund of any Mortgage Insurance premiums that were unearned at the time of such cancellation or termination.

11. Assignment of Miscellaneous Proceeds; Forfeiture. All Miscellaneous Proceeds are hereby assigned to and shall be paid to Lender.

If the Property is damaged, such Miscellaneous Proceeds shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened. During such repair and restoration period, Lender shall have the right to hold such Miscellaneous Proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender may pay for the repairs and restoration in a single disbursement or in a series of progress payments as the work is completed. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such Miscellaneous Proceeds, Lender shall not be required to pay Borrower any interest or earnings on such Miscellaneous Proceeds. If the restoration or repair is not economically feasible or Lender's security would be lessened, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such Miscellaneous Proceeds shall be applied in the order provided for in Section 2.

In the event of a total taking, destruction, or loss in value of the Property, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower.

In the event of a partial taking, destruction, or loss in value of the Property in which the fair market value of the Property immediately before the partial taking, destruction, or loss in value is equal to or greater than the amount of the sums secured by this Security Instrument immediately before the partial taking, destruction, or loss in value, unless Borrower and Lender otherwise agree in writing, the sums secured by this Security Instrument shall be reduced by the amount of the Miscellaneous Proceeds multiplied by the following fraction: (a) the total amount of the sums secured immediately before the partial taking, destruction, or loss in value divided by (b) the fair market value of the Property immediately before the partial taking, destruction, or loss in value. Any balance shall be paid to Borrower.

In the event of a partial taking, destruction, or loss in value of the Property in which the fair market value of the Property immediately before the partial taking, destruction, or loss in value is less than the amount of the sums secured immediately before the partial taking, destruction, or loss in value, unless Borrower and Lender otherwise agree in writing, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument whether or not the sums are then due.

If the Property is abandoned by Borrower, or if, after notice by Lender to Borrower that the Opposing Party (as defined in the next sentence) offers to make an award to settle a claim for damages, Borrower fails to respond to Lender within 30 days after the date the notice is given, Lender is authorized to collect and apply the Miscellaneous Proceeds either to restoration or repair of the Property or to the sums secured by this Security Instrument, whether or not then due. "Opposing Party" means the third party that owes Borrower Miscellaneous Proceeds or the party against whom Borrower has a right of action in regard to Miscellaneous Proceeds.

Borrower shall be in default if any action or proceeding, whether civil or criminal, is begun that, in Lender's judgment, could result in forfeiture of the Property or other material impairment of Lender's interest in the Property or rights under this Security Instrument. Borrower can cure such a default and, if acceleration has occurred, reinstate as provided in Section 19, by causing the action or proceeding to be dismissed with a ruling that, in Lender's judgment, precludes forfeiture of the Property or other material impairment of Lender's interest in the Property or rights under this Security Instrument. The proceeds of any award or claim for damages that are attributable to the impairment of Lender's interest in the Property are hereby assigned and shall be paid to Lender.

All Miscellaneous Proceeds that are not applied to restoration or repair of the Property shall be applied in the order provided for in Section 2.

12. Borrower Not Released; Forbearance By Lender Not a Waiver.

Extension of the time for payment or modification of amortization of the sums secured by this Security Instrument granted by Lender to Borrower or any Successor in Interest of Borrower shall not operate to release the liability of Borrower or any Successors in Interest of Borrower. Lender shall not be required to commence proceedings against any Successor in Interest of Borrower or to refuse to extend time for payment or otherwise modify amortization of the sums secured by this Security Instrument by reason of any demand made by the original Borrower or any Successors in Interest of Borrower. Any forbearance by Lender in exercising any right or remedy including, without limitation, Lender's acceptance of payments from third persons, entities or Successors in Interest of Borrower or in amounts less than the amount then due, shall not be a waiver of or preclude the exercise of any right or remedy.

13. Joint and Several Liability; Co-signers; Successors and Assigns

Bound. Borrower covenants and agrees that Borrower's obligations and liability shall be joint and several. However, any Borrower who co-signs this Security Instrument but does not execute the Note (a "co-signer"):

- (a) is co-signing this Security Instrument only to mortgage, grant and convey the co-signer's interest in the Property under the terms of this Security Instrument;
- (b) is not personally obligated to pay the sums secured by this Security Instrument; and
- (c) agrees that Lender and any other Borrower can agree to extend, modify, forbear or make any accommodations with regard to the terms of this Security Instrument or the Note without the co-signer's consent.

Subject to the provisions of Section 18, any Successor in Interest of Borrower who assumes Borrower's obligations under this Security Instrument in writing, and is approved by Lender, shall obtain all of Borrower's rights and benefits under this Security Instrument. Borrower shall not be released from Borrower's obligations and liability under this Security Instrument unless Lender agrees to such release in writing. The covenants and agreements of this Security Instrument shall bind (except as provided in Section 20) and benefit the successors and assigns of Lender.

14. Loan Charges. Lender may charge Borrower fees for services performed in connection with Borrower's default, for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument, including, but not limited to, attorneys' fees, property inspection and valuation fees. In regard to any other fees, the absence of express authority in this Security Instrument to charge a specific fee to

Borrower shall not be construed as a prohibition on the charging of such fee. Lender may not charge fees that are expressly prohibited by this Security Instrument or by Applicable Law.

If the Loan is subject to a law which sets maximum loan charges, and that law is finally interpreted so that the interest or other loan charges collected or to be collected in connection with the Loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from Borrower which exceeded permitted limits will be refunded to Borrower. Lender may choose to make this refund by reducing the principal owed under the Note or by making a direct payment to Borrower. If a refund reduces principal, the reduction will be treated as a partial prepayment without any prepayment charge (whether or not a prepayment charge is provided for under the Note). Borrower's acceptance of any such refund made by direct payment to Borrower will constitute a waiver of any right of action Borrower might have arising out of such overcharge.

15.Notices. All notices given by Borrower or Lender in connection with this Security Instrument must be in writing. Any notice to Borrower in connection with this Security Instrument shall be deemed to have been given to Borrower when mailed by first class mail or when actually delivered to Borrower's notice address if sent by other means. Notice to any one Borrower shall constitute notice to all Borrowers unless Applicable Law expressly requires otherwise. The notice address shall be the Property Address unless Borrower has designated a substitute notice address by notice to Lender. Borrower shall promptly notify Lender of Borrower's change of address. If Lender specifies a procedure for reporting Borrower's change of address, then Borrower shall only report a change of address through that specified procedure. There may be only one designated notice address under this Security Instrument at any one time. Any notice to Lender shall be given by delivering it or by mailing it by first class mail to Lender's address stated herein unless Lender has designated another address by notice to Borrower. Any notice in connection with this Security Instrument shall not be deemed to have been given to Lender until actually received by Lender. If any notice required by this Security Instrument is also required under Applicable Law, the Applicable Law requirement will satisfy the corresponding requirement under this Security Instrument.

16.Governing Law; Severability; Rules of Construction. This Security Instrument shall be governed by federal law and the law of the jurisdiction in which the Property is located. All rights and obligations contained in this Security Instrument are subject to any requirements and limitations of Applicable Law. Applicable Law might explicitly or implicitly allow the parties to agree by contract or it might be silent, but such

silence shall not be construed as a prohibition against agreement by contract. In the event that any provision or clause of this Security Instrument or the Note conflicts with Applicable Law, such conflict shall not affect other provisions of this Security Instrument or the Note which can be given effect without the conflicting provision.

As used in this Security Instrument: (a) words of the masculine gender shall mean and include corresponding neuter words or words of the feminine gender; (b) words in the singular shall mean and include the plural and vice versa; and (c) the word "may" gives sole discretion without any obligation to take any action.

17.Borrower's Copy. Borrower shall be given one copy of the Note and of this Security Instrument.

18.Transfer of the Property or a Beneficial Interest in Borrower.

As used in this Section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.

If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.

If Lender exercises this option, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

19.Borrower's Right to Reinstate After Acceleration. If Borrower meets certain conditions, Borrower shall have the right to have enforcement of this Security Instrument discontinued at any time prior to the earliest of: (a) five days before sale of the Property pursuant to any power of sale contained in this Security Instrument; (b) such other period as Applicable Law might specify for the termination of Borrower's right to reinstate; or (c) entry of a judgment enforcing this Security Instrument. Those conditions are that Borrower: (a) pays Lender all sums which then would be due under this Security Instrument and the Note as if no acceleration had occurred; (b) cures any default of any other covenants or agreements; (c) pays all expenses incurred in

enforcing this Security Instrument, including, but not limited to, reasonable attorneys' fees, property inspection and valuation fees, and other fees incurred for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument; and (d) takes such action as Lender may reasonably require to assure that Lender's interest in the Property and rights under this Security Instrument, and Borrower's obligation to pay the sums secured by this Security Instrument, shall continue unchanged. Lender may require that Borrower pay such reinstatement sums and expenses in one or more of the following forms, as selected by Lender: (a) cash; (b) money order; (c) certified check, bank check, treasurer's check or cashier's check, provided any such check is drawn upon an institution whose deposits are insured by a federal agency, instrumentality or entity; or (d) Electronic Funds Transfer. Upon reinstatement by Borrower, this Security Instrument and obligations secured hereby shall remain fully effective as if no acceleration had occurred. However, this right to reinstate shall not apply in the case of acceleration under Section 18.

20.Sale of Note; Change of Loan Servicer; Notice of Grievance. The Note or a partial interest in the Note (together with this Security Instrument) can be sold one or more times without prior notice to Borrower. A sale might result in a change in the entity (known as the "Loan Servicer") that collects Periodic Payments due under the Note and this Security Instrument and performs other mortgage loan servicing obligations under the Note, this Security Instrument, and Applicable Law. There also might be one or more changes of the Loan Servicer unrelated to a sale of the Note. If there is a change of the Loan Servicer, Borrower will be given written notice of the change which will state the name and address of the new Loan Servicer, the address to which payments should be made and any other information RESPA requires in connection with a notice of transfer of servicing. If the Note is sold and thereafter the Loan is serviced by a Loan Servicer other than the purchaser of the Note, the mortgage loan servicing obligations to Borrower will remain with the Loan Servicer or be transferred to a successor Loan Servicer and are not assumed by the Note purchaser unless otherwise provided by the Note purchaser.

Neither Borrower nor Lender may commence, join, or be joined to any judicial action (as either an individual litigant or the member of a class) that arises from the other party's actions pursuant to this Security Instrument or that alleges that the other party has breached any provision of, or any duty owed by reason of, this Security Instrument, until such Borrower or Lender has notified the other party (with such notice given in compliance with the requirements of Section 15) of such alleged breach and afforded the other party hereto a reasonable period after the giving of such notice to take corrective action. If Applicable Law

provides a time period which must elapse before certain action can be taken, that time period will be deemed to be reasonable for purposes of this paragraph. The notice of acceleration and opportunity to cure given to Borrower pursuant to Section 22 and the notice of acceleration given to Borrower pursuant to Section 18 shall be deemed to satisfy the notice and opportunity to take corrective action provisions of this Section 20.

21. Hazardous Substances. As used in this Section 21: (a) "Hazardous Substances" are those substances defined as toxic or hazardous substances, pollutants, or wastes by Environmental Law and the following substances: gasoline, kerosene, other flammable or toxic petroleum products, toxic pesticides and herbicides, volatile solvents, materials containing asbestos or formaldehyde, and radioactive materials; (b) "Environmental Law" means federal laws and laws of the jurisdiction where the Property is located that relate to health, safety or environmental protection; (c) "Environmental Cleanup" includes any response action, remedial action, or removal action, as defined in Environmental Law; and (d) an "Environmental Condition" means a condition that can cause, contribute to, or otherwise trigger an Environmental Cleanup.

Borrower shall not cause or permit the presence, use, disposal, storage, or release of any Hazardous Substances, or threaten to release any Hazardous Substances, on or in the Property. Borrower shall not do, nor allow anyone else to do, anything affecting the Property (a) that is in violation of any Environmental Law, (b) which creates an Environmental Condition, or (c) which, due to the presence, use, or release of a Hazardous Substance, creates a condition that adversely affects the value of the Property. The preceding two sentences shall not apply to the presence, use, or storage on the Property of small quantities of Hazardous Substances that are generally recognized to be appropriate to normal residential uses and to maintenance of the Property (including, but not limited to, hazardous substances in consumer products).

Borrower shall promptly give Lender written notice of (a) any investigation, claim, demand, lawsuit or other action by any governmental or regulatory agency or private party involving the Property and any Hazardous Substance or Environmental Law of which Borrower has actual knowledge, (b) any Environmental Condition, including but not limited to, any spilling, leaking, discharge, release or threat of release of any Hazardous Substance, and (c) any condition caused by the presence, use or release of a Hazardous Substance which adversely affects the value of the Property. If Borrower learns, or is notified by any governmental or regulatory authority, or any private party, that any removal or other remediation of any Hazardous Substance affecting the Property is necessary, Borrower shall promptly take all necessary remedial actions in

accordance with Environmental Law. Nothing herein shall create any obligation on Lender for an Environmental Cleanup.

NON-UNIFORM COVENANTS. Borrower and Lender further covenant and agree as follows:

22.Acceleration; Remedies. Lender shall give notice to Borrower prior to acceleration following Borrower's breach of any covenant or agreement in this Security Instrument (but not prior to acceleration under Section 18 unless Applicable Law provides otherwise). The notice shall specify: (a) the default; (b) the action required to cure the default; (c) a date, not less than 30 days from the date the notice is given to Borrower, by which the default must be cured; and (d) that failure to cure the default on or before the date specified in the notice may result in acceleration of the sums secured by this Security Instrument and sale of the Property. The notice shall further inform Borrower of the right to reinstate after acceleration and the right to bring a court action to assert the non-existence of a default or any other defense of Borrower to acceleration and sale. If the default is not cured on or before the date specified in the notice, Lender at its option may require immediate payment in full of all sums secured by this Security Instrument without further demand and may invoke the power of sale and any other remedies permitted by Applicable Law. Lender shall be entitled to collect all expenses incurred in pursuing the remedies provided in this Section 22, including, but not limited to, reasonable attorneys' fees and costs of title evidence.

If Lender invokes the power of sale, Lender shall execute or cause Trustee to execute a written notice of the occurrence of an event of default and of Lender's election to cause the Property to be sold. Trustee shall cause this notice to be recorded in each county in which any part of the Property is located. Lender or Trustee shall mail copies of the notice as prescribed by Applicable Law to Borrower and to the other persons prescribed by Applicable Law. Trustee shall give public notice of sale to the persons and in the manner prescribed by Applicable Law. After the time required by Applicable Law, Trustee, without demand on Borrower, shall sell the Property at public auction to the highest bidder at the time and place and under the terms designated in the notice of sale in one or more parcels and in any order Trustee determines. Trustee may postpone sale of all or any parcel of the Property by public announcement at the time and place of any previously scheduled sale. Lender or its designee may purchase the Property at any sale.

Trustee shall deliver to the purchaser Trustee's deed conveying the Property without any covenant or warranty, expressed or implied. The recitals in the Trustee's deed shall be prima facie evidence of the truth of the statements made therein. Trustee shall apply the proceeds of the sale in the following order: (a) to all expenses of the sale, including, but

not limited to, reasonable Trustee's and attorneys' fees; (b) to all sums secured by this Security Instrument; and (c) any excess to the person or persons legally entitled to it.

23.Reconveyance. Upon payment of all sums secured by this Security Instrument, Lender shall request Trustee to reconvey the Property and shall surrender this Security Instrument and all notes evidencing debt secured by this Security Instrument to Trustee. Trustee shall reconvey the Property without warranty to the person or persons legally entitled to it. Lender may charge such person or persons a reasonable fee for reconveying the Property, but only if the fee is paid to a third party (such as the Trustee) for services rendered and the charging of the fee is permitted under Applicable Law. If the fee charged does not exceed the fee set by Applicable Law, the fee is conclusively presumed to be reasonable.

24.Substitute Trustee. Lender, at its option, may from time to time appoint a successor trustee to any Trustee appointed hereunder by an instrument executed and acknowledged by Lender and recorded in the office of the Recorder of the county in which the Property is located. The instrument shall contain the name of the original Lender, Trustee and Borrower, the book and page where this Security Instrument is recorded and the name and address of the successor trustee. Without conveyance of the Property, the successor trustee shall succeed to all the title, powers and duties conferred upon the Trustee herein and by Applicable Law. This procedure for substitution of trustee shall govern to the exclusion of all other provisions for substitution.

25.Statement of Obligation Fee. Lender may collect a fee not to exceed the maximum amount permitted by Applicable Law for furnishing the statement of obligation as provided by Section 2943 of the Civil Code of California.

BY SIGNING BELOW, Borrower accepts and agrees to the terms and covenants contained in this Security Instrument and in any Rider executed by Borrower and recorded with it.

Witnesses:

Borrower

Borrower

(Seal)

[Space Below This Line for Acknowledgment]

SPECIAL LOAN CLAUSES

A number of special provisions may be included in trust deeds, mortgages, and promissory notes. They are designed to protect both the lender and the borrower.

PURCHASE MONEY

This term refers to actual money or credit used to acquire the property made as security for the loan.

- ♦ **Seller Financing** - Any secured credit extended by a seller is "purchase money."
- ♦ **Refinancing** - Refinancing of any kind is **not** "purchase money."
- ♦ **Transferability** - Once a loan is "purchase money," the sale of the note or assumption of the debt does not change its status.
- ♦ **Limitations** - No deficiency judgment on purchase money is allowed if the lien was created by:
 - Credit extended by the seller.
 - Financing used to purchase an owner-occupied dwelling of 4 units or less.
- ♦ **Effect** - The effect of these statutory limitations is to give limited liability to the home buyer. Thus, there is less risk to borrowing money for purchase of a home than for any other purpose.

ACCELERATION CLAUSE

An **ACCELERATION CLAUSE** gives the lender the right to "call" all sums owed to the lender, immediately due and payable upon the happening of certain specified events.

DUE-ON-SALE CLAUSE/ALIENATION CLAUSE

An **ALIENATION CLAUSE** (also known as *due-on-sale clause*) is a special kind of acceleration clause permitting the lender to call the loan if the borrower alienates (conveys or transfers) title. The clause must be stated specifically in the note as well as the trust deed to be enforceable. Benefits the lender.

- ♦ **Federal Statute** - The Garn-St. Germain Depository Institutions Act of 1982 preempted state prohibitions on the exercise of due-on-sale clauses by all lenders.
- ♦ **Due-On-Sale Now Enforceable** - On October 15, 1985, all grace periods terminated, and due-on-sale clauses generally became enforceable except in very limited prescribed circumstances. [should this and the previous bulleted item be included—since it's so dated?]
- ♦ **Exemptions** - On loans secured by liens on residential property of less than five units, a lender may not exercise a due-on-sale clause upon:
 - Creation of a junior lien
 - Creation of a purchase money security interest for household appliances
 - The death of a joint tenant
 - A lease of three years or less not containing an option to purchase transfer to a relative upon death of the borrower
 - A transfer to the spouse or children of the borrower
 - Dissolution of marriage
 - Transfer into an inter-vivos trust with no transfer of occupancy.

ASSIGNMENT OF RENTS CLAUSE

The standard short form for recording is called "deed of trust and assignment of rents." This clause is customary in most trust deeds.

ASSIGNMENT OF RENTS CLAUSE provides that upon default by the trustor, the beneficiary may take possession of the property through a court appointed trustee and collect rents applying them to the loan and to the costs and expenses incurred.

PREPAYMENT PENALTY CLAUSE

PREPAYMENT PENALTY CLAUSE allows the lender to charge the penalty imposed on the borrower, stated in the note and trust deed, for early payoff of the loan or any substantial part thereof. It is termed "punitive interest" and tax deductible as such, and benefits the lender.

This penalty is usually specified as a certain number of months interest on the unpaid balance to be paid in addition to the amount owed to date. The amounts and times are limited by law in California.

- ♦ **Civil Code** - For owner-occupied homes, the penalty is restricted during the first five years as follows:
 - Up to 20 percent of the original loan amount may be prepaid in any 12-month period without penalty.
 - For amounts paid over this, the borrower may be charged no more than six months' interest penalty.
- ♦ **Real Estate Law** - Loans regulated by Article 7 of the Real Estate law (those negotiated by real estate brokers) have slightly different prepayment penalty limitations on owner-occupied single-family dwellings, and may extend through seven years.
 - Up to 20 percent of the unpaid balance may be prepaid in any 12-month period.
 - For amounts paid over this the borrower may be charged no more than six months' interest penalty.

OR MORE CLAUSE

An **OR MORE CLAUSE** specifies that the borrower may pay more than the required periodic payment specified in the note, including the right to pay off the entire balance at any time. A note containing an "or more" clause may or may not have a prepayment penalty. Benefits the borrower.

PARTIAL RELEASE CLAUSE

A **PARTIAL RELEASE CLAUSE** provides for reconveyance of each lot by the beneficiary as each lot is sold, when the encumbrance covers two or more parcels.

SUBORDINATION CLAUSE

A **SUBORDINATION CLAUSE** is an agreement that the lender will relinquish priority to a subsequent lien. The clause is generally used to subordinate the loan to a construction loan to be obtained later. It benefits the borrower.

POWER OF SALE CLAUSE

A **POWER OF SALE CLAUSE** enables nonjudicial sale of property possible in the event of default by the borrower. Properly written trust deeds always contain a power of sale. Mortgages generally must be foreclosed judicially, unless a power of sale clause has been specially incorporated. It benefits the lender.

BALLOON PAYMENT CLAUSE

A **BALLOON PAYMENT** is that more than double the amount of a regular installment.

The balloon payment mortgage, although used in financing commercial properties, has not met with huge success in financing homes because of the balloon feature. Unless the note calls for a rollover, there is no assurance that the loan will be rewritten with a new rate at maturity. Thus balloon payment home loans are frequently seller carryback loans used during tight or high-interest, mortgage markets.

☞ A balloon loan provides the "balance" is all due and payable at a specified time.

Comparison of Trust Deed and Mortgage

Parties	Trust Deed Three Parties Trustor: The borrower who signs the note and trust deed and conveys title to trustee. Remains equitable owner. Beneficiary The lender who holds note and trust deed. Trustee: (neutral third party) The receiver of "naked legal title" from trustor (authorization to sell in the event of default.) He will reconvey title when the debt is paid, or sell through a trustee's sale.	Mortgage Two Parties Mortgagor: The borrower who signs the note and retains the legal title. Has possession and use. Mortgagee: The lender who holds the note and mortgage contract.
Payment in Full	Note and trust deed is sent to a trustee by beneficiary, who signs a "Request for Full Reconveyance." A trustee signs and issues a reconveyance deed, which is recorded to clear the lien from the public records. A reconveyance deed does not convey title to a new buyer.	When loan is paid, mortgagee issues a "Certificate of Discharge," which is recorded to clear the lien from the public records.
Title	Conveyed to trustee with trustor	Retained by mortgagor

REAL ESTATE FINANCE

	retaining possession of the property.	together with possession.
Default Breach	Beneficiary can choose either a trustee's sale (most expedient- requires about four months) or a foreclosure through the courts. If foreclosed through the courts, the court foreclosure rules apply.	Can usually be foreclosed only through the judicial court foreclosure, unless the mortgage contains a power of sale clause.
Statute of Limitation	There is no time limit since trustee has title and power of sale.	Foreclosure is barred if no action is taken within four years of delinquency. Mortgage is said to have "outlawed."
Foreclosure	Trustee's Sale 1. Beneficiary notifies trustee default. 2. Trustee records "<i>Notice of Default</i>" and notifies trustor, subsequent recorded lienors and all others who have requested notice. 3. Trustee waits at least three months. During three-month period, trustor can reinstate loan. 4. After three months, trustee advertises "notice of sale" in a newspaper of general circulation once a week for three weeks and posts notice on property. 5. Trustor can reinstate the loan (pay the back payments and penalties) up until five days before the sale. 6. Trustee conducts sale and issues a trustee's deed to the highest bidder. Note: Trustor owns and possesses property until the sale and could redeem it or sell it him or herself.	Mortgage Sale Court Foreclosure Sale 1. Mortgagee brings court action. 2. Court orders property sold. 3. Commissioner appointed by the court advertises "notice of sale" once a week for three weeks and posts notice on property. 4. A certificate of sale is issued at time of sale to the buyer. 5. Mortgagor has one year to redeem property (pay loan in full, statutory right of redemption) and to remain in possession (liable for reasonable rent). 6. A sheriff's deed is issued one year after the sale.
Redemption Right	When title has been sold by trustee at trustee's sale, no right of redemption exists.	Mortgagor has up to one year to redeem following court foreclosure; called " <i>Equity of Redemption</i> ."

Deficiency Judgment	Not available if: 1.The foreclosure is by the trustee's sale. 2.On purchase money trust deeds.	Available in a court foreclosure unless the mortgage was a purchase money mortgage.

EFFECTS OF SECURITY

A security interest such as a mortgage or trust deed affects the borrower's ability to transfer the property, creates a creditor's interest which can be transferred, and imposes certain conditions regarding liens and termination of the interest.

ASSIGNMENT BY CREDITOR

These security instruments can be transferred like any other property or instrument. However, the note and the security device must go together.

- ♦ **Inseparable Instruments** - The assignment of a note requires the assignment of the security interest, and vice versa.
 - An attempted assignment of the security interest without the note transfers nothing to the assignee.
 - A transfer of the note without the mortgage or trust deed gives the assignee the right to the security.
- ♦ **Recording** - Any assignment of the security interest in a mortgage or trust deed may be recorded. This recording gives constructive notice of assignment. After an assignment is recorded, the debtor is not protected if making payments to the original creditor instead of the assignee.

TRANSFER OF PROPERTY

Upon transfer of property which has been mortgaged, the property still remains subject to the mortgage.

- ♦ **Assumption** - By assumption of an existing debt, the grantee becomes the primary debtor. Secondary liability still exists for the original borrower unless released by the lender.
 - The person granted the property (grantee) cannot be held liable for a deficiency judgment unless the grantee assumed the mortgage.
 - The mortgagor is still liable for payments to the mortgagee despite the grant unless given a release of liability.
 - For certain purchase money loans, remedy of the mortgagee is against the property only (no deficiency judgment.)

- ♦ **In Writing** - Any agreement by a buyer to pay a debt secured by a mortgage must be in writing.
- ♦ **Beneficiary Statement** - A "beneficiary statement" is obtained when a new purchaser acquires a mortgage or trust deed which already exists. Furnished by the lender, it is a statement of the current condition of the debt containing:
 - Unpaid balance
 - Interest payments
 - Any other claims that do not appear in the instrument

SATISFACTION OF DEBT

A mortgage or trust deed should be terminated when the debt is satisfied.

- ♦ **Full Payment by the Debtor** - Signified by cancellation of the note and issuance of the reconveyance deed or satisfaction of mortgage. The lien is removed from the property when the release instrument is recorded.
- ♦ **Foreclosure Sale** - If the debtor fails to pay, foreclosure is accomplished either out of court (no deficiency judgment) or in court (deficiency judgment possible except in the case of most purchase money trust deeds.)

LIEN PRIORITIES

Liens take precedence usually in the order of recordation time, unless modified by a subordination clause or by operation of law, as in the case of a mechanics or a judgment lien.

- ♦ **Legal Notice** - The concept of notice is an important element in establishing priority. It can be: actual notice (express or implied.)
- ♦ **Tax liens** - Taxes and assessments are usually on a par with each other and take priority over other liens including a trust deed or mortgage.

PROMISSORY NOTE SECURED BY DEED OF TRUST

1. For value received, ☐ I individually ☐ We jointly and severally
promise to pay to the order of

\$_____ at _____
☐ with interest at the rate of _____% per year: [**choose one**]
from the date this note is signed until the date it is due or is paid in full,
whichever date occurs last.

☐ from the date this note is signed until the date it is paid in full.

2. The signer(s) of this note also agree that this note shall be paid in
installments, which include principal and interest, of not less than \$
_____ per month, due on the first day of each month, until such
time as the principal and interest are paid in full.

3. If any installment payment due under this note is not received by the
holder within _____ days of its due date, the entire amount of unpaid
principal shall become immediately due and payable at the option of the
holder without prior notice to the signer(s) of this note.

4. If the holder(s) of this note prevail(s) in a lawsuit to collect on it, the
signer(s) agree(s) to pay the holder(s)' attorney fees in an amount the
court finds to be just and reasonable.

5. Signer(s) agree(s) that until such time as the principal and interest
owed under this note are paid in full, the note shall be secured by a deed
of trust to real property commonly known as
_____, owned by
_____, executed on,
_____, at on _____, and recorded on
in the records of _____ County, California.

Address Location (city or county)

Date Date

Signature of Borrower Signature of Borrower

State of California

County of _____

On _____, before me, _____, a notary public in and for said state, personally appeared , personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument, and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies) and that by his/her/their signature(s) on the instrument the person(s), or entity upon behalf of which the person(s) acted, executed the instrument.

Signature of Notary [SEAL]

CHAPTER 8 QUIZ

1. A person who is an innocent purchaser of a negotiable note for value without knowledge of any defect is customarily called:
 - A. A holder in due course
 - B. An assignor
 - C. A receiver in trust
 - D. An endorser in blank
2. A fictitious deed of trust:
 - A. Is a trust deed recorded against a single title to real property
 - B. Is a forged trust deed
 - C. Does not cite a specific property
 - D. Is a recorded form of trust deed referred to in other trust deeds subsequently recorded in that county
3. Reinstatement under a trust deed is possible:
 - A. Up to five business days prior to sale
 - B. Anytime prior to sale
 - C. Within three months after sale
 - D. Up to one year after sale depending on sale proceeds
4. A note and mortgage requires a borrower to protect the lender by paying all of the following, **except**:
 - A. Property taxes
 - B. Life insurance premiums for borrower
 - C. Hazard insurance premiums
 - D. Principal and interest payments
5. A trust deed that is in default may be foreclosed:
 - A. Only by going to court
 - B. Foreclosure is barred if no action taken within four years of delinquency.
 - C. By trustee's sale only
 - D. None of the above
6. When a borrower has defaulted on a loan, and the lender chooses judicial foreclosure, the mortgagor is given a specified period of time to redeem the property. During this redemption period, the right of possession of the property is held by the:
 - A. Mortgagee

- B. Court-appointed trustee
 - C. Beneficiary
 - D. Mortgagor
7. An alienation clause:
- A. Is a due-on-sale clause
 - B. Conveys the title of a property to a transferee
 - C. Gives a lender the right to "call" a loan
 - D. Both A and C
8. A deficiency judgment may be granted by a court for a loan which is:
- A. Used for the purchase of an owner-occupied dwelling
 - B. For a second trust deed note secured at the time of purchase, foreclosed upon a personal residence
 - C. A refinance on an owner-occupied residence for the purpose of home improvements
 - D. None of the above
9. Under the Uniform Commercial Code, when an individual has satisfied a debt, the document that releases the lien of a previously filed financing statement is a:
- A. Satisfaction of mortgage
 - B. Termination statement
 - C. Reconveyance
 - D. Paid-in-full statement
10. The Garn-St. Germain Act preempted state regulations on due-on-sale clauses and prescribes those due-on-sale clauses:
- A. Are not enforceable
 - B. Are enforceable only in mortgages
 - C. Are enforceable only in trust deeds
 - D. Are enforceable with certain exceptions

*Chapter 8 Answers: 1-A, 2-C, 3-A, 4-B, 5-B, 6-D, 7-D, 8-C, 9-C,
10-A*

CHAPTER 9: FIXED RATE MORTGAGE AND ALTERNATIVE MORTGAGE INSTRUMENTS



PREVIEW

This chapter is designed to distinguish between fixed-rate mortgage and another types of mortgage instruments, including the alternative mortgage instrument. We will talk about the reasons behind the expanded use of alternative mortgage instruments, adjustable rate mortgage, convertible ARMs, buy-down, graduated payment, growing equity, shared-appreciation and reverse annuity mortgages.

Adjustable rate mortgages (ARMs) and other alternative mortgage instruments (AMIs) are financing instruments that compete against the standard fixed-rate, fully amortized loan program. This competition has been evolving for over 30 years.

TYPES OF MORTGAGES

Although the characteristics of the two instruments vary, in this book the word "mortgage" will be used interchangeably with "deed of trust."

Mortgages can be divided into two distinct groups: alternative and standard. In alternative mortgages at least one of the four basic characteristics of a deed of trust is varied. Those characteristics are:

1. Interest rate
2. Payments, varied by time or amount
3. Repayment term
4. Negative amortization

With a standard deed of trust, characteristics 1 through 3 do not change. The amount of principal, however, decreases with each payment.

FIXED RATE MORTGAGE

In **FIXED RATE MORTGAGE**, the payments on fixed-rate are constant over the life of the mortgage, thus the borrower may budget for or plan on a fixed payment. In addition to the fixed-payment feature, the borrower starts to build equity from the first payment. With the budget mortgage, the principal and interest (P & I) portion of the payment does not vary. The only variable in the payment is the amount needed to pay the taxes, insurance, private mortgage insurance (if any) and any other fees may affect the title to the property. The amount that will be collected for the is the total amount due each year divided by 12.

Because the borrower starts to build equity with the first month's payment, let us calculate the amount of principal reduction and the amount of the interest charges for the first three payments of a 30-year, fixed-rate, and fixed-term loan. The deed of trust amount is \$85,000; the interest rate is 8 percent. The first step is to calculate the monthly payment. This can be done using several methods, including a payment book, a financial calculator, or the use of monthly payment factors.

For this example, we've used the **monthly payment factor (MPF)**, defined as an amount that is necessary to repay a loan of \$1000 at a specific interest rate for a specific number of years. In this example we need the factor of a 30-year loan at 8 percent. In Figure below the monthly payment factors (MPF) are listed for 15-, 20-, 25-, and 30-year mortgages for interest rates from 7 to 17 percent. Find the proper interest rate of 8.125 percent in the first column, and then go across the row under the proper heading that describes the term-30 years or 360 months in the far right column. The MPF is 7.4250. This means that we will repay the loan at the rate of \$7.4250 per \$1000 borrowed. To calculate the monthly payment (P & I only), we would multiple the monthly payment factor (MPF) times the loan amount divided by 1000, or:

$$\text{Monthly Payment} = \text{MPF} \times \text{Loan Amount} / 1000$$

For our example we would then insert the proper numbers in the formula:
 $\$7.4250 \times \$85,000 / 1000 = \$631.125$

Monthly payment for P & I only would equal \$631.125 or \$631.13.

Now let us calculate the amount of the first payment that will go to pay the interest charges and the amount of the payment that will be credited to principal reduction.

We calculate the amount of interest that would be charged on the loan amount for a full year.

$$\$85,000 \times 8.0 \text{ percent} = \$6,800$$

Because we only need the amount for 1 month, we divide this amount by 12 months or $\$6,800 / 12 = \$566.67$

The first interest payment is \$566.67 and the remainder of the total payment of \$631.13 -- \$631.13 minus \$566.67 or \$64.46 -- would be credited to principal reduction. The balance on the loan would be the original loan amount minus the \$64.46 or \$84,935. To calculate the amount of principal reduction for the second payment, multiply the new loan amount by the annual interest rate of 8.0 percent (0.08) to get the annual interest rate. Divide that by 12 to get the monthly interest, then subtracting that amount from the total P & I payment of \$631.13, giving the amount that would go to principal reduction:

1. Annual interest: $\$84,935.54 \times 8.0 \text{ percent} = \$6,794.84$
2. Monthly Interest Charge: $\$6794.85 / 12 = \$566.24$
3. Principal Reduction: $\$631.13 - \$566.24 = \$64.89$

These calculations show that in the first years of the loan the major portion of each payment goes to the payment of interest. Many times borrowers asks "How much will I pay back on my loan?" This is simple to calculate. Multiply the monthly payment for P & I by the total number of payments.

To calculate the amount of interest that would be paid over the term of the loan, subtract the original loan amount from the total amount repaid or

$$\$227,206.80 - \$85,000 = \$142,206.80$$

With these simple steps and the monthly payment factors, a real estate professional can calculate the above for any fixed-rate (from 7 to 17 percent), fixed-term (15-, 20-, 25-, or 30-year) mortgage.

Figure 9-1: Monthly Payment Factors for \$1000 Loan Amounts

Interest rate	15 years	20 years	25 years	30 years
7.000	8.9882	7.7530	7.0678	6.6530
7.125	9.0583	7.8282	7.1477	6.7372
7.250	9.1286	7.9038	7.2281	6.8218

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7.375	9.1992	7.9797	7.3088	6.9067
7.500	9.2701	8.0559	7.3899	6.9921
7.625	9.3413	8.1325	7.4714	7.0779
7.750	9.4128	8.2095	7.5533	7.1641
7.875	9.4845	8.2868	7.6355	7.2507
8.000	9.5565	8.3644	7.7182	7.3376
8.125	9.6288	8.4424	7.8012	7.4250
8.250	9.7014	8.5207	7.8845	7.5127
8.375	9.7743	8.5993	7.9682	7.6007
8.500	9.8474	8.6782	8.0523	7.6891
8.625	9.9208	8.7575	8.1367	7.7779
8.750	9.9945	8.8371	8.2214	7.8670
8.875	10.0684	8.9170	8.3065	7.9565
9.000	10.1427	8.9973	8.3920	8.0462
9.125	10.2172	9.0778	8.4777	8.1363
9.250	10.2919	9.1587	8.5638	8.2268
9.375	10.3670	9.2398	8.6502	8.3175
9.500	10.4423	9.3213	8.7370	8.4085
9.625	10.5178	9.4031	8.8240	8.4999
9.750	10.5936	9.4852	8.9114	8.5915
9.875	10.6697	9.5675	8.9990	8.6835
10.000	10.7461	9.6502	9.0870	8.7757
10.125	10.8227	9.7332	9.1753	8.8682
10.250	10.8995	9.8164	9.2638	8.9610
10.375	10.9766	9.8999	9.3527	9.0541
10.500	11.0540	9.9838	9.4418	9.1474
10.625	11.1316	10.0679	9.5312	9.2410
10.750	11.2095	10.1523	9.6209	9.3348
10.875	11.2876	10.2370	9.7109	9.4289
11.000	11.3659	10.3219	9.8011	9.5232
11.125	11.4446	10.4070	9.8916	9.6178
11.250	11.5234	10.4926	9.9824	9.7126
11.375	11.6026	10.5783	10.0734	9.8077
11.500	11.6819	10.6643	10.1647	9.9029
11.625	11.7615	10.7506	10.2562	9.9984
11.750	11.8413	10.8371	10.3480	10.0941
11.875	11.9214	10.9238	10.4400	10.1900
12.000	12.0017	11.0109	10.5322	10.2861
12.125	12.0822	11.0981	10.6247	10.3824
12.250	12.1630	11.1856	10.7174	10.4790
12.375	12.2440	11.2734	10.8104	10.5757
12.500	12.3252	11.3614	10.9035	10.6726
12.625	12.4067	11.4673	11.0156	10.7697
12.750	12.4884	11.5381	11.0905	10.8669
12.875	12.5703	11.6268	11.1843	10.9644
13.000	12.6524	11.7158	11.2784	11.0620

13.125	12.7348	11.8049	11.3726	11.1598
13.250	12.8174	11.8943	11.4670	11.2577
13.375	12.9002	11.9839	11.5616	11.3558
13.500	12.9832	12.0737	11.6564	11.4541
13.625	13.0664	12.1638	11.7515	11.5525
13.750	13.1499	12.2541	11.8467	11.6511
13.875	13.2335	12.3445	11.9420	11.7498

ALTERNATIVE MORTGAGE INSTRUMENTS (AMI)

The ***ALTERNATIVE MORTGAGE INSTRUMENT*** is the type in which at least one of the four basic mortgage characteristics varies. The importance of AMIs has grown in the last few years because the increase in home prices has meant that fewer persons can qualify for housing. In the past, AMIs were thought to be a creative method of financing the real estate transaction, but today they are becoming the standard.

The AMI is becoming more common in the real estate industry as interest rates rise and real estate financing become less available. The AMI appeals to lenders because it allows the lender's return from the mortgage to keep up with the prevailing interest rate. It appeals borrowers because many of the AMIs allow borrowers to qualify for a larger mortgage amount by making the initial monthly payments lower and increasing them over a specified time as the borrower's income increases. Some of the more common AMIs and many of the newest AMIs will be discussed in this chapter.

ADJUSTABLE RATE MORTGAGES

In the 1970s over 50 types of instruments were developed for financing with variable terms. These included the variable interest rate loan, roll-over mortgage, renegotiable rate mortgage, graduated payment mortgage, adjustable mortgage loan, and adjustable rate mortgage. Of these, the ARM is the most widely used in California.

DRE REFERENCE BOOK

The "**Reference Book**" of the California Department of Real Estate outlines the origin and development of adjustable rate financing and the consumer issues involved:

Since FHA created the long-term, fixed-rate amortized mortgage loan in 1934, it has been the standard traditional form of financing for home purchases. In a stable economic environment, involving little or no inflation and relatively constant market interest rates, these long-term,

fixed-rate instruments meet most of the practical needs of both lenders and borrowers.

Unpredictable inflation rates and uncertain future interest rates have made "traditional" financing unsuitable for many lenders and unrealistic or impossible for many borrowers. As interest rates increase, lenders are required to pay higher interest rates to attract deposits. Lenders who have invested in long-term, fixed-rate mortgage instruments at lower interest rates experience serious, even ruinous economic problems. If lenders make loans only at interest rates high enough to reduce this risk, borrowers generally are less willing to borrow and fewer prospective borrowers will qualify for loans.

Alternative mortgage instruments are the means by which lenders and borrowers respond to economic conditions. The peculiar needs of different kinds of lenders, as well as of the different classes of borrowers who are in need of credit to consummate home purchases (e.g., those borrowers whose incomes tend to keep pace with inflation, as distinguished from those whose dollar incomes do not increase sufficiently to maintain a constant real purchasing power), mean that there is no single optimum alternative mortgage plan that will suit all possible creditor-debtor combinations. Selecting the appropriate mortgage instrument is of enormous importance to both the lender and the borrower, and both should approach the mortgage selection process with great care and attention to the mutual needs and interests.

Historically, lenders have a problem with cycles of tight and loose money. This unsteady flow of funds is disruptive to their operations and to the housing industry. When money is tight, it flows out of thrift institutions because depositors can obtain higher yields elsewhere. This is the phenomenon described in Chapter 2 as disintermediation.

Advocates of alternative loans say that this problem can be reduced by using **adjustable rate mortgages**. If money gets tight and interest rates rise, the thrift institutions should be allowed to increase the rate they pay their depositors in order to prevent an outflow of savings. However, in order to pay higher interest on savings accounts, lenders must receive a higher interest rate on their existing loans. With an adjustable rate mortgage, lenders could increase interest rates on their existing loans when they need to increase the interest rate to attract or keep savings accounts. This overcomes the problem referred to as "borrowing short and lending long." Savings and checking deposits constitute loans from depositors to the financial institutions, for which they pay a modest return to the depositor, who usually keeps funds for very short periods. A home loan to that same depositor would commit the financial institution to a long term, typically 30 years.

LEGISLATION

In 1983 federal legislation set up new regulations replacing those established during the "formative" years of alternative mortgage instruments. These new regulations allowed more flexibility for both federally chartered banks and savings and loan associations in offering adjustable rate mortgages, or ARMs.

CHARACTERISTICS OF ARM

The principal objective of ARMs is to transfer some of the risk of continually rising inflation from the lender to the borrower, while at the same time tailoring loans more closely to the borrower's financial circumstances.

With a fixed-rate mortgage, the interest rate remains the same during the life of the loan. But with an ARM, an adjustable rate mortgage, the interest rate changes periodically, usually in relation to an index, and payments may go up or down accordingly.

LOW INITIAL RATE

Lenders generally charge lower initial interest rates for ARMs than for fixed-rate mortgages. This makes the ARM easier on the pocketbook at first than a fixed-rate mortgage for the same amount. It also means that one might qualify for a larger loan because lenders sometimes make this decision on the basis of current income and the first year's payments. Moreover, an ARM could be less expensive over a long period than a fixed-rate mortgage—for example, if interest rates remain steady or decrease.

TEASER RATES

In highly competitive markets, lenders offer so called *teaser* rates. **TEASER RATES** are abnormally low rates designed to attract borrowers.

Once the loans are granted, the low teaser rate soon disappears and the usually higher ARM rates take effect. The low teaser rate allows some buyers to qualify for a loan that they would not otherwise be able to obtain. Some lenders are now offering teaser rates but insist that the borrower be able to qualify at the normal or "fully indexed" ARM rate.

HIGHER FUTURE PAYMENTS

Against these advantages, there is the risk that an increase in interest rates will lead to higher monthly payments in the future. It's a trade-off--a lower initial rate in exchange for assuming more risk. Here are some questions the borrower needs to consider:

- ♦ Is my income likely to rise enough to cover higher mortgage payments if interest rates go up?
- ♦ Will I be taking on other sizable debts, such as a loan for a car or tuition, in the near future?
- ♦ How long do I plan to own this home? (If one plans to sell soon, rising interest rates may not pose the problem they do if one plans to own the house for a long time.)
- ♦ Can my payments increase even if interest rates generally do not increase?

HOW DOES AN ARM WORK?

The basic features of any ARM is the adjustment period (frequency of adjustment), the index on which the adjustments are based, and the margin charged by the lender. At the end of each adjustment period, the ARM interest rate for the ensuing period is determined by the formula:

$$\text{ARM Interest Rate} = \text{Index Rate} + \text{Margin}$$

CHARACTERISTICS OF ARM LOANS

INDEX

Once the initial interest rate is established, the rate is tied to some neutral **index**, which is one that is beyond the control of the lender or the borrower. A government index, such as the "**cost of funds index**" of the 11th District of the Federal Home Loan Bank of San Francisco, is an example. Some ARMs are tied to certain U.S. Treasury notes. Others are tied to international indexes, such as the London Interbank Offered Rate (LIBOR).

The borrower should know what index will be used, how often it changes, how it has behaved in the past, and where it is published.

MARGIN

To determine the interest rate on an ARM, lenders add to the index rate a few percentage points called the "**MARGIN**." The amount of the margin can differ from one lender to another, but it is usually constant over the life of the loan. In comparing ARMs, both the index and margin are important. Some indexes have higher average values, but they are usually used with lower margins.

ADJUSTMENT PERIOD

Currently, the interest rate and monthly payment changes for most ARMs occur every six months. Some ARMs have different interest and payment changes, and borrower and lender may agree upon any period they choose. The period between one rate change and the next is called the adjustment period. A loan with an adjustment period of six months is called a six-month ARM.

- ♦ Borrowers must be notified at least 30 days prior to a change. After notification, the borrower usually has a 90-day opportunity to pay off the loan without penalty-referred to as the "window period."

PAYMENT CAPS

To avoid what is known as "payment shock," most ARMs have **interest rate caps** -- a ceiling on annual and total interest rate increases. A **maximum of a two percent per year** increase is typical with a five to six percent total increase allowed over the initial contract rate. For example, if an ARM starts out at four percent, the maximum increase in any one year might be two percent, with a lifetime maximum of six percent (**or a high of 10 percent for the life of the loan**). ARMs must also show the "floor," the lowest rate to which the loan may go, in addition to the ceiling. Sometimes floor rates can go as far down as up.

Example: Index and Margin

Suppose one is comparing ARMs offered by two different lenders. Both ARMs are for 30 years, and the loan amount is \$65,000. (Note that the payment amounts shown here do not include items like taxes or insurance.)

Both lenders use the one-year Treasury index. But the first lender uses a two percent margin, and the second lender uses a three percent margin. Here is how that difference in margin would affect the initial monthly payment.

Mortgage amount \$65,000

First lender
One-year index 8 %
Margin = 2 %
ARM interest rate = 10 %
Monthly payment = \$570.42

Second lender
One-year index = 8 %
Margin = 3 %
ARM interest rate = 11 %
Monthly payment = \$619.01

Example: Rate Cap

At a time when market interest rates might be at 6.5 percent, initial teaser rates could be offered at 4.5 percent, instead of at the then fully-indexed 6.5 percent rate. The lifetime cap of five percent usually applies to the fully-indexed 6.5 percent rate, not the 4.5 percent teaser rate, producing an 11.5 percent maximum rate for the life of the loan.

DISCOUNTS

Some lenders offer initial ARM rates that are lower than the sum of the index and the margin. Such below-market rates, called discounted rates, are often combined with large initial loan fees ("points") and with higher interest rates after the discount expires.

- ♦ **Risk** - All ARMs are to some extent a gamble on the future movement of interest rates, but the risk is compounded by the use of discounts. The borrower must decide in each situation if the initial advantage is worth the risk.
- ♦ **Seller Buydown** - Very large discounts are often arranged by the seller. The seller pays an amount to the lender so the lender can offer a lower rate and lower payments early in the mortgage term. This arrangement is referred to as a "seller buydown." The seller may increase the sales price of the home to cover the cost of the buydown.
- ♦ **Other Buydown** - Borrowers may also be able to negotiate buydowns of the terms of ARMs.
- ♦ **Qualifying** - A lender may use a low initial rate to decide whether to approve a loan, based on the borrower's ability to make payments. Borrowers must seriously consider whether they will be able to afford payments in later years when the discount expires and the rate is adjusted.
- ♦ **Future Payment Shock** - With a discounted ARM, the low initial payment will probably not remain low for long and any saving during the discounted period will normally be made up during the life of the mortgage, or be included in the price of the house. "Payment shock" may occur if the mortgage payment rises sharply at the first adjustment.

Example: Discounts

Here is how a discount might work. Let's assume the one year ARM rate (index rate plus margin) is at 10 percent. But the lender is offering an eight percent rate for the first year. With the eight percent rate, the first-year monthly payment would be \$476.95.

Let's see what happens in the second year with the discounted 10 percent ARM.

ARM Interest Rate	Monthly Payment
First year (with discount) 8%	\$476.95
2nd year at 10%	\$568.82

As the example shows, even if the index rate stays the same, the monthly payment goes up from \$476.95 to \$568.82 in the second year.

Suppose that the index rate increases two percent in one year and the ARM rate rises to a level of 12 percent.

ARM Interest Rate	Monthly Payment
First year (with discount) 8%	\$476.95
2nd year at 12%	\$665.43

That's an increase of almost \$200 in monthly payments

NEGATIVE AMORTIZATION AND ADJUSTABLE RATE MORTGAGES

NEGATIVE AMORTIZATION can arise during times of high inflation. Rapid inflation creates a need to qualify a borrower at a low entry level rate of interest even though the payments will later increase to accommodate full amortization of the loan over a particular term of years.

In some cases, the initial monthly payments may be inadequate to cover the interest, let alone provide for any principal reduction. Whatever the amount of the interest shortfall, it is added to the existing principal balance of the loan, and the following month, the process is repeated. Since the interest shortfall is always added to the principal balance, the borrower ends up paying interest on interest, and the principal balance grows with compounding effect.

Example:

You borrow \$100,000 at nine percent with payments of \$600 per month. The first month's interest should be $\$100,000 \times 9\% = \$9,000$ divided by 12 months = \$750 per month to cover the interest. But since you pay only \$600, you are short \$150 on the interest portion. This \$150 is added

to the existing loan amount of \$100,000, resulting in a new balance of \$100,150 after the first month's payment of \$600. The second month's calculation would be $\$100,150 \times 9\% = \$9,013.50$ divided by 12 months = \$751.13, less the second payment of \$600 = \$151.13 shortage. This \$151.13 shortage would be added to the previous balance of \$100,150 to bring the new balance to \$100,301.13 and the process would continue with each subsequent monthly payment of \$600. As you can see, the negative amortization just continues to increase the size of the loan balance due.

Some of the original ARMs contained provisions by which the negative amortization on an 80 percent LTV loan could produce a loan balance equal to 125 percent of the original debt. When the loan reached this point, it was obviously equal to the value of the security property, and the note then required that the loan be automatically recast, with the introduction of new monthly payments scheduled to fully amortize the loan over the remaining term. The result was that many owners lost their homes through foreclosure; loan provisions had to, and did, change.

It is important to note that two changes can take place in connection with an ARM: a change in the interest rate and a change in the monthly payment. One can occur without the other. If changes in the payments are not made concurrently to accommodate the higher interest rates, negative amortization can take place, resulting in a debt increase rather than a decrease. There has been a definite movement by lenders away from granting real estate loans with negative amortization.

ADVANTAGES OF ARM

Adjustable rate mortgages and similar instruments have advantages in periods of rapidly changing market conditions.

- ♦ ARMs allow the market rather than the government to regulate interest rate fluctuations.
- ♦ They give the lender mortgage loan incentives, by maintaining an interest rate commensurate with lender's cost of funds. Institutional lenders tend to be wary of long-term, fixed-rate loans during periods of tight money, high interest rates, inflation, recession, or stagflation.
- ♦ Lower initial rates when compared with fixed rates.
- ♦ Easier qualifying for home purchases in many cases.
- ♦ Initial costs of the loan are usually smaller.
- ♦ Ability to qualify for a larger loan at the lower interest rate.
- ♦ ARMs respond to the needs of housing demand (borrower's needs), by providing for lower payments in the early years of the loan, or by offering assurance that a temporarily high market interest rate

will not prevail for the entire life of the loan. In some cases, the lower rate can mean a larger loan and a larger house.

- ♦ Generally easier assumability upon resale.
- ♦ No prepayment penalties.

DISADVANTAGES OF ARMS

- ♦ Income may not increase proportionately with increases in payments.
- ♦ In a slow real estate market, the rate of appreciation may be less than the rate of increase in the interest rates; that is, the spread between the value of the property and the outstanding loan balance could shrink annually, rather than increase.
- ♦ In some cases, the prospect for negative amortization means that borrowers may owe more than they would net out of the resale proceeds if the property is sold in the early years.
- ♦ The risk of rising interest rates is borne partly by the borrower, since the risk of change in the cost of funds can be shifted entirely to the borrower, within maximum caps allowed over the life of the loan.

CALIFORNIA ADJUSTABLE-RATE NOTE

The notes that will be reviewed in this section are those issued by Fannie Mae/FHLMC with four notes in the series. All of these notes use U.S. Treasury Securities as an index.

ADJUSTABLE-RATE NOTE (1 YEAR TREASURY INDEX RATE CAPS)

This note is shown in Form 9-1. The top of the first page of the note states in bold type that the note contains provisions that allow the interest rate and monthly payment to change. This note limits the amount the interest may change at any adjustment or change date and states the maximum interest rate the borrower will pay.

Section 1 is identical to the fixed-rate note. It states that the borrower promises to pay to the lender an amount with interest.

Section 2 states that the interest will be charged on the unpaid balance and at a yearly rate of _____ percent, as well as stating that the interest rate will change in accordance with Section 4 of the note.

Section 3 is divided into three subsections. Subsection A, Time and Place of Payments, is identical to the California fixed-rate note. Subsections B and C are unique to this note. Subsection B, Amount of My Initial Monthly Payments, will state the payment in dollars. Because this is an adjustable-

rate note and is adjusted annually, Subsection C states that the interest rate and payment will change.

In Subsection A of Section 4, Interest Rate and Monthly Payment Changes, the change date is established for the first change and as the subsection states, the interest rate will change on that day every year thereafter.

Subsection B establishes the interest-rate index that will be used. For the note and all of the Fannie Mae/FHLMC California adjustable-rate notes, the index will be the 1-, 3-, or 5-year Treasury securities. Because this note will be adjusted annually, the 1-year Treasury security will be used as the index for this note. As you will notice, the note is specific. The index will be the weekly average yield of the 1-year Treasury security. As we learned in our study of the ARM disclosures, the lender must identify what will be used as the current index. This information is also contained in this subsection.

In subsection C, Calculation of Changes, you will note that the lender will calculate the new interest rate by adding a certain spread or margin to the current index. In addition, this subsection allows the lender to round the interest rate to the nearest one-eighth. Using the new interest rate and the remaining term, the lender will calculate the new monthly payment that would be required to pay the loan off over the remaining term.

Subsections D, E, and F deal with limiting the increase in the interest rate. Subsection D limits the interest rate increase or decrease to no more than one percent in any 12-month period. In addition to limiting the amount of increase per adjustment date, the note states the interest rate the borrower will pay will not be greater than _____ percent or less than _____ percent. This percentage will not be more than the initial interest rate plus the margin of five percent.

Subsection E establishes the effective date of changes, and Subsection F states the time, method, and content of the rate and payment change notice the lender must give to the borrower.

Section 5, Borrower's Right to Prepay, is similar to the fixed-rate note explained earlier.

Section 7, Borrower's Failure to Pay as Required, gives the lender the right to impose a late charge if the payment is not received, usually by the 15th of the month. In addition, it states that if the borrower does not pay on the date the payment is due, he or she will be in default and, if the borrower does go into default, the lender may send a notice that the

borrower is in default. Finally, in this section the borrower agrees to pay the lender for his or her costs in enforcing the note.

The remainder of the note is very similar to the fixed rate note and is self-explanatory.

FIGURE 9-2: ADJUSTABLE RATE NOTE (LIBOR INDEX AND RATE CAPS)

REAL ESTATE FINANCE

ADJUSTABLE RATE NOTE

(LIBOR One-Year Index (As Published In *The Wall Street Journal*)—Rate Caps)

THIS NOTE CONTAINS PROVISIONS ALLOWING FOR CHANGES IN MY INTEREST RATE AND MY MONTHLY PAYMENT. THIS NOTE LIMITS THE AMOUNT MY INTEREST RATE CAN CHANGE AT ANY ONE TIME AND THE MINIMUM AND MAXIMUM RATES I MUST PAY.

_____, _____, _____
[City] [State]

[Property Address]

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. \$ _____ (this amount is called "Principal"), plus interest, to the order of the Lender. The Lender is _____. I will make all payments under this Note in the form of cash, check or money order.

I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder."

2. INTEREST

Interest will be charged on unpaid principal until the full amount of Principal has been paid. I will pay interest at a yearly rate of _____. The interest rate I will pay will change in accordance with Section 4 of this Note.

The interest rate required by this Section 2 and Section 4 of this Note is the rate I will pay both before and after any default described in Section 7(B) of this Note.

3. PAYMENTS

(A) Time and Place of Payments

I will pay principal and interest by making a payment every month.

I will make my monthly payment on the first day of each month beginning on _____. I will make these payments every month until I have paid all of the principal and interest and any other charges described below that I may owe under this Note. Each monthly payment will be applied as of its scheduled due date and will be applied to interest before Principal. If, on _____, 20____, I still owe amounts under this Note, I will pay those amounts in full on that date, which is called the "Maturity Date."

I will make my monthly payments at _____ or at a different place if required by the Note Holder.

(B) Amount of My Initial Monthly Payments

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Each of my initial monthly payments will be in the amount of U.S. \$ _____. This amount may change.

(C) Monthly Payment Changes

Changes in my monthly payment will reflect changes in the unpaid principal of my loan and in the interest rate that I must pay. The Note Holder will determine my new interest rate and the changed amount of my monthly payment in accordance with Section 4 of this Note.

4. INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Change Dates

The interest rate I will pay may change on the first day of _____, _____, and on that day every 12th month thereafter. Each date on which my interest rate could change is called a "Change Date."

(B) The Index

Beginning with the first Change Date, my interest rate will be based on an Index. The "Index" is the average of interbank offered rates for one-year U.S. dollar-denominated deposits in the London market ("LIBOR"), as published in *The Wall Street Journal*. The most recent Index value available as of the date 45 days before each Change Date is called the "Current Index," provided that if the Current Index is less than zero, then the Current Index will be deemed to be zero for purposes of calculating my interest rate.

If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me notice of this choice.

(C) Calculation of Changes

Before each Change Date, the Note Holder will calculate my new interest rate by adding _____ percentage points (_____ %) (the "Margin") to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date.

The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the Maturity Date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

(D) Limits on Interest Rate Changes

The interest rate I am required to pay at the first Change Date will not be greater than _____ % or less than _____ %. Thereafter, my interest rate will never be increased or decreased on any single Change Date by more than two percentage points from the rate of interest I have been paying for the preceding 12 months. My interest rate will never be greater than _____ % or less than the Margin.

(E) Effective Date of Changes

My new interest rate will become effective on each Change Date. I will pay the amount of my new monthly payment beginning on the first monthly payment date after the Change Date until the amount of my monthly payment changes again.

(F) Notice of Changes

The Note Holder will deliver or mail to me a notice of any changes in my interest rate and the amount of my monthly payment before the effective date of any change. The notice will include information required by law to be given to me and also the title and telephone number of a person who will answer any question I may have regarding the notice.

5. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a "Prepayment." When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate a payment as a Prepayment if I have not made all the monthly payments due under the Note.

I may make a full Prepayment or partial Prepayments without paying a Prepayment charge. The Note Holder will use my Prepayments to reduce the amount of Principal that I owe under this Note. However, the Note Holder may apply my Prepayment to the accrued and unpaid interest on the Prepayment amount, before applying my Prepayment to reduce the Principal amount of the Note. If I make a partial Prepayment, there will be no changes in the due dates of my monthly payment unless the Note Holder agrees in writing to those changes. My partial Prepayment may reduce the amount of my monthly payments after the first Change Date following my partial Prepayment. However, any reduction due to my partial Prepayment may be offset by an interest rate increase.

6. LOAN CHARGES

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the Principal I owe under this Note or by making a direct payment to me. If a refund reduces Principal, the reduction will be treated as a partial Prepayment.

7. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charges for Overdue Payments

If the Note Holder has not received the full amount of any monthly payment by the end of _____ calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be _____ % of my overdue payment of principal and interest. I will pay this late charge promptly but only once on each late payment.

(B) Default

If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.

(C) Notice of Default

If I am in default, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date, the Note Holder may require me to pay immediately the full amount of Principal which has not been paid and all the interest that I owe on that amount. That date must be at least 30 days after the date on which the notice is mailed to me or delivered by other means.

(D) No Waiver By Note Holder

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(E) Payment of Note Holder's Costs and Expenses

If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees.

8. GIVING OF NOTICES

Unless applicable law requires a different method, any notice that must be given to me under this Note will be given by delivering it or by mailing it by first class mail to me at the Property Address above or at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by delivering it or by mailing it by first class mail to the Note Holder at the address stated in Section 3(A) above or at a different address if I am given a notice of that different address.

9. OBLIGATIONS OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each person is fully and personally obligated to keep all of the promises made in this Note, including the promise to pay the full amount owed. Any person who is a guarantor, surety or endorser of this Note is also obligated to do these things. Any person who takes over these obligations, including the obligations of a guarantor, surety or endorser of this Note, is also obligated to keep all of the promises made in this Note. The Note Holder may enforce its rights under this Note against each person individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note.

10. WAIVERS

I and any other person who has obligations under this Note waive the rights of Presentment and Notice of Dishonor. "Presentment" means the right to require the Note Holder to demand payment of amounts due. "Notice of Dishonor" means the right to require the Note Holder to give notice to other persons that amounts due have not been paid.

11. UNIFORM SECURED NOTE

This Note is a uniform instrument with limited variations in some jurisdictions. In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust, or Security Deed (the "Security Instrument"), dated the same date as this Note, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note. That Security Instrument describes how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note. Some of those conditions are described as follows:

If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law. Lender also shall not exercise this option if: (a) Borrower causes to be submitted to Lender information required by Lender to evaluate the intended transferee as if a new loan were being made to the transferee; and (b) Lender reasonably determines that Lender's security will not be impaired by the

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loan assumption and that the risk of a breach of any covenant or agreement in this Security Instrument is acceptable to Lender.

To the extent permitted by Applicable Law, Lender may charge a reasonable fee as a condition to Lender's consent to the loan assumption. Lender may also require the transferee to sign an assumption agreement that is acceptable to Lender and that obligates the transferee to keep all the promises and agreements made in the Note and in this Security Instrument. Borrower will continue to be obligated under the Note and this Security Instrument unless Lender releases Borrower in writing.

If Lender exercises the option to require immediate payment in full, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

WITNESS THE HAND(S) AND SEAL(S) OF THE UNDERSIGNED.

(Seal)
-Borrower

(Seal)
-Borrower

(Seal)
-Borrower

[Sign Original Only]

HOW CAN THE BORROWER REDUCE THE RISK?

Choosing an ARM solely because of its low initial rate can be risky. Borrowers can look for mortgages with features designed to reduce such risks. Many ARMs have "caps" that protect borrowers from extreme increases in interest rates or monthly payments. Others allow borrowers to convert an ARM to a fixed-rate mortgage. However, these features may cost more or add risks of their own, such as negative amortization.

- ♦ **Interest Rate Caps** - An interest rate cap places a limit on the amount the interest rate can increase. A cap is like insurance, and ARMs with caps may cost more than ARMs. There are two types: periodic caps limit the interest-rate increase from one adjustment period to the next; overall caps limit the interest rate increase over the life of the loan. An ARM may have both.

Example: Periodic Cap

Consider an ARM with a periodic interest-rate cap of two percent. At the first adjustment, the index rate goes up three percent. The example shows what happens.

ARM Interest Rate	Monthly Payment
First year at 10%	\$570.42
2 nd year at 13% (without cap)	\$717.12
2 nd year at 12% (with cap)	\$667.30

Difference in second year between payment with the cap and payment without the cap = \$49.82

- ♦ **Deferred Increase** - A drop in interest rates does not always lead to a drop in monthly payments. In fact, with some ARMs with interest rate caps, the payment amount may increase at a given adjustment period even though the index rate has stayed the same or declined. This may happen after an interest rate cap has been holding the interest rate down below the sum of the index plus margin.

Example: Increase Deferred by Periodic Cap

In this example there is a periodic cap of two percent on the ARM, and the index went up three percent at the first adjustment. If the index stays the same in the third year, the rate will go up to 13 percent, making up the one percent not added the previous year.

ARM Interest Rate	Monthly Payment
First year at 10%	\$570.42

If index rises 3%, 2nd year at 12% \$667.30
(with 2% rate cap)
If the index stays the same, 3rd year \$716.56
at 13%

Even though index stays the same, payment goes up \$49.26.

In general, the rate on the loan can go up at any scheduled adjustment when the index plus the margin is higher than the rate before that adjustment.

- ♦ **Overall Cap** - An ARM may also have an overall interest rate cap. The next example shows the effects of a five percent overall rate cap. Suppose the index rate increases one percent in each of the first 10 years:

Example: Overall Cap

ARM Interest Rate	Monthly Payment
First year at 10%	\$570.42
10th year at 19% (without a cap)	\$1,008.64
10th year at 14% (with a cap)	\$764.08

With a five percent overall rate cap, the monthly payment would never exceed \$764.08, no matter how much rates rise.

- ♦ **Payment Caps** - Some ARMs include payment caps, which limit the monthly payment increase at the time of each adjustment, usually to a percentage of the previous payment. In other words, with a seven-plus percent payment cap, a payment of \$100 could increase to no more than \$107.50 in the first adjustment period and to no more than \$115.56 in the second.

Example: Payment Caps

Assume that the rate changes in the first year by two percentage points, but payments can increase by no more than seven-and-a-half percent in any one year.

Here is how the monthly payments would be affected:

ARM Interest Rate	Monthly Payment
First year at 10%	\$570.42
2nd year at 12% (without payment cap)	\$667.30
2nd year at 12% (with 7½% payment cap)	\$613.20
Difference in monthly payment =	\$54.10

Many ARMS with payment caps do not have periodic interest rate caps.

NEGATIVE AMORTIZATION

Because payment caps limit only payment increases, and not interest rate increases, payments held down by a cap may not cover all of the interest due on the loan. "Negative amortization" may occur if an ARM contains a payment cap. Negative amortization means the mortgage balance is increasing because monthly mortgage payments are not large enough to pay all of the interest due on the mortgage.

- ♦ **Increased Debt** - The interest shortage in each payment is automatically added to the debt, and interest may be charged on that amount. Therefore, the borrower might owe the lender more later in the loan term than at the start. An increase in the value of the home may make up for the increase in what is owed, so an ARM with negative amortization may still be an acceptable risk.

Example: Negative Amortization

Using the figures from the preceding example, here is how negative amortization works during one year. The first 12 payments of \$570.42, based on a 10 percent interest rate, paid the balance down to \$64,638.72 at the end of the first year. The rate goes up to 12 percent in the second year. But because of the 72 percent payment cap, payments are not high enough to cover all the interest. The interest shortage is added to the debt (with interest on it), which produces negative amortization of \$420.90 during the second year.

Beginning loan amount = \$65,000

Loan amount at end of first year \$64,638.72

Negative amortization during 2nd year = \$420.90

Loan amount at end of 2nd year = \$65,059.82 (\$64,638.72 + \$420.90)

If the house is sold at this point, the owner would owe almost \$60 more than the amount originally borrowed.

- ♦ **Increased Payments** - The payment cap limits increases in monthly payments by deferring some of the increase in interest. Eventually, the borrower will have to repay the higher remaining loan balance at the ARM rate then in effect. When this happens, there may be a substantial increase in the monthly payment.
- ♦ **Negative Amortization Caps** - Some mortgages contain a cap on negative amortization. It typically limits the total amount one can owe to 125 percent of the original loan amount. When that point is reached, monthly payments may be set to fully repay the loan over the remaining term, and the payment cap may not apply. A

borrower may limit negative amortization by voluntarily increasing the monthly payment.

- ♦ **Prepayment** - Many ARMs allow the borrower to pay the loan in full or in part without penalty whenever the rate is adjusted. Some agreements may require special fees or penalties in order to pay off the ARM early. Sometimes, prepayment details are negotiable. If so, the borrower may want to negotiate for no penalty, or for as low a penalty as possible.
- ♦ **Conversion** - If a buyer gets an ARM and financial circumstances change, the borrower may decide not to risk any further changes in the interest rate and payment amount. The agreement with the lender can include a clause that allows the borrower to convert the ARM to a fixed-rate mortgage at a designated time. The converted rate is generally set at the current market rate for fixed-rate mortgages. In exchange for this flexibility, the interest rate or up-front fees may be higher for a convertible ARM, and there may be a special fee at the time of conversion.

ARM DISCLOSURES (REGULATION Z)

The 1988 Regulation Z amendments were the first disclosures specifically designed for the increasingly popular variable-rate instruments. Before the amendments, only the standard truth in lending disclosures were made, and they came late in the financing process (when actual costs were fully known) and could not accurately reflect the effects of variable terms.

The newer disclosures, using a \$10,000 model loan example and a historical summary of the index being used, are able to give the borrower a clear picture of how payments and loan balance may be affected by a variable interest rate. The essential features of an ARM are specifically addressed in these disclosures: the index used, how interest rate and payment are determined, frequency of adjustment, caps, and the possibility of negative amortization.

REQUIREMENTS

Regulation Z amendments require creditors to provide consumers with an educational booklet about adjustable rate mortgages, and to provide a detailed description of the variable rate feature, along with a historical example.

- ♦ **Application** - The amendments apply only to closed-end credit transactions secured by the consumer's principal dwelling, including

both purchase money and non-purchase money, for terms of more than one year.

- ♦ **Timing** - The information must be provided:
 - At the time an application form is given to the consumer or,
 - Before the consumer pays a non-refundable fee, whichever is earlier.
- ♦ Disclosure at this time is possible under the amendments because the new rule requires that disclosure reflect ARM loan program features, but not the terms of individual transactions.
- ♦ **Two Disclosures** - Under the new rule, the variable rate disclosures are given to consumers earlier than the standard Truth in lending information. The later truth in lending disclosures must include a statement that an adjustable-rate feature exists and that the variable-rate disclosures have been provided to the consumer.

DISCLOSURE CONTENTS

- ♦ **Educational Booklet** - The Federal Reserve's Consumer Handbook on Adjustable Rate Mortgages or another booklet containing comparable information must be provided by the lender to a prospective borrower at the time an application form is given to the consumer or before the consumer pays a non-refundable fee, whichever is earlier.
- ♦ **ARM Features** - Creditors are required to specify the following:
 - The index to which interest rate changes are tied
 - A source of information about the index
 - An explanation of how the interest rate and payment will be determined, for example, a statement that the interest rate will be based on a specified index plus a margin and that the payment will be based on the interest rate, the loan balance, and the remaining loan term
 - A statement that will alert consumers about a discount feature when the initial rate is discounted
 - The frequency of rate and payment adjustments
 - If the presence of rate or payment caps can result in negative amortization, a statement about those features
 - The existence of a demand feature, if applicable
 - A statement describing the type of information that will be contained in an adjustment notice
 - When adjustment notices will be provided.
- ♦ Negative amortization features, if any.
- ♦ Maximum caps on both the amount interest increase and the total for the loan.

The lender may comply with Regulation Z by giving the potential borrower the ***Consumer Handbook on Adjustable Rate Mortgages***, published by the Federal Reserve and the Federal Home Loan Bank Board. In addition, California lenders are required to have the borrower sign an adjustable rate loan rider to the promissory note.

SUBSEQUENT DISCLOSURES

Each adjustment to the interest rate in a variable-rate transaction, with or without a corresponding adjustment to the payment, is an event requiring new disclosures to the consumer.

- ♦ **Timing** - Disclosures are required at least once a year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25, but not more than 120, calendar days before a payment at a new level is due.
- ♦ **Disclosure Contents** - The following disclosures, as applicable, must be delivered or placed in the mail:
 - The current and prior interest rates
 - The applicable index values
 - The contractual effects of the adjustment, including the payment due after the adjustment, and a statement of the loan balance
 - The payment (if different from above) that would fully amortize the loan at the new interest rate over the remaining loan term.
- ♦ **Adjustment Period Notice** - Notice is required whenever interest rate adjustments and corresponding payment adjustments can be made periodically under the loan agreement, even if they are not made because, for example, the index values have not changed or an interest rate cap has prevented any adjustments.
- ♦ **Other Agency Disclosures** - Information provided in accordance with variable rate subsequent disclosure regulations of other federal agencies may be substituted for the disclosures required by Regulation Z.

CONVERTIBLE MORTGAGE

There are times when prospective borrowers are torn between the initial low payments of the adjustable rate loan with the possibility of large increases in future payments, and a ***fixed rate loan*** with the initial higher, but predictable monthly payment. The ARM is low now but could

increase to more than the present fixed rate loan. Borrowers ask themselves; do I go adjustable or fixed? One answer may be a convertible rate loan.

A **CONVERTIBLE RATE** loan is a hybrid that typically starts as an adjustable rate loan but contains the option to switch to a fixed rate loan at some later date. Or it may be the reverse: the loan starts as a fixed rate and later can be switched to an ARM. For this privilege, borrowers usually pay slightly higher initial rates than for conventional (i.e., nonconvertible) ARMs. There are many varieties of convertible rate loans. A borrower needs to ask: when can I convert? How much will it cost? Do I get the prevailing fixed interest rate or a higher-than-market fixed rate? Let's look at each, ARM to fix and fixed to ARM, to answer some of these questions.

ARM TO FIXED CONVERSION

This type of ARM was developed to counteract many borrower's fears of future increases in the interest rate on their mortgages.

With this type of ARM, the borrower is given the option to convert to a fixed-term, fixed-rate mortgage. This conversion may be a one-time option or the lender may offer the borrower an option to convert on any adjustment date. This conversion is normally offered on the 1-, 3-, or 5-year ARMs. If the borrower has a 3-year ARM with a conversion option at the first adjustment date, the borrower could opt to convert to a fixed rate, fixed-term 27-year mortgage at the first adjustment date. Convertible ARMs offer the option of conversion at any adjustment date, and the borrower opts to convert on the second adjustment date, then the borrower would have a fixed rate, fixed-term 24-year mortgage.

The borrower might opt to convert if the interest rate, at the time of adjustment had fallen to a level at which the borrower felt he or she could make the payments. For example, if a borrower had received an ARM in August 1999 when the rates on the 3 and 5-year ARMs were in the 9 to 10 percent range, then at the first adjustment date, when the rate on a fixed-term, fixed-rate mortgage had fallen to 8 percent, a conversion may have been a good option. The advantage of this conversion over time is a function of the level of interest rates.

As with any type of loan, the convertible ARM will require the borrower to sign a note and deed of trust, but because this is not a standard ARM the lender may have to require the borrower and/or borrower to sign some additional documents. A lender has two options. One is to use one of the standard ARM notes, note addendum, and deed of trust addendum to the ARM deed of trust rider. If a lender uses these documents, two additional documents will have to be signed by the borrower and/or co-borrower,

Addendum to Adjustable Rate/Graduated Payment Note (Fixed Rate Conversion Option), and Addendum to Adjustable Rate /Graduated Payment Rider (Fixed Rate Conversion Option). These are to be used with an ARM based on a 1 -year Treasury index, but the same documents are available for use with an ARM based on a 3 - or 5-year Treasury index.

As the title indicates, these documents may also be used with a graduated payment mortgage, allowing the borrower to convert the GPM to a fixed-rate mortgage. These documents outline the steps to be followed to convert an ARM or GPM to a fixed-rate mortgage, as well as how the fixed rate of interest will be calculated.

The other option available to the lender is the use of an FHLMC convertible ARM note. This note is similar to the ARM notes covered in the previous section. There is one major difference: paragraph 5, Conversion to Fixed Interest Rate. Section A indicates on which change date the borrower will be allowed to convert. This could be the first or the first, second, and third or any change dates specified in this section. Section B states how the fixed rate will be established. Finally, in Section C, borrowers are advised that if they should convert, they will have to sign a document as evidence of the modification of the note.

FIXED TO ARM CONVERSIONS

A wide variety of ARM loans are offered with fixed to ARM convertible features. They may come with labels like 1/1 ARM, 3/1 ARM, 5/1 ARM, 7/1 ARM, 10/1 ARM, and so on. The first number represents the number of years the rate is fixed, and the second designates how often the rate may adjust thereafter. For the 5/1 ARM, for instance, the rate is fixed for five years, and then converts to a one-year ARM, usually adjustable thereafter each year for the life of the loan. In general, the larger the first number (that is, the larger the fixed rate term), the higher the interest rate. For example, lenders may quote 6 percent interest for a 1/1, 6.5 percent for a 3/1, and 7 percent for a 5/1 ARM, with one discount point for each.

OTHER AMI/CREATIVE FINANCING ALTERNATIVES

Non-traditional forms of financing can be examined in several other categories, including those where the seller assists by lending, cooperating in the assumption of a loan, or other ways, such as those where a lender provides concessions in exchange for a future benefit, etc.

JUNIOR TRUST DEED (SECONDARY TDS)

A "**JUNIOR TRUST DEED**" or a "**JUNIOR LIEN**" or *secondary financing mortgage*, is any trust deed or mortgage that is not a first trust deed.

A junior loan is any claim subordinate to (junior to) another claim against the security

When the current financial market is tight, or when a buyer does not have enough cash to cover the difference between the sale price and the loan amount, another loan or "second" trust deed is sometimes obtained (often from the seller).

- ♦ Priority is established by time of recording. The risk of a junior lienholder is higher and lenders therefore usually demand a higher interest rate.
- ♦ The beneficiary of a junior loan should record a request for notice of default so that he will be protected if the borrower defaults on a prior loan.
- ♦ The basic protection for the lender is the borrower's equity.
- ♦ Private lenders are the greatest source of junior loans.
- ♦ A second TD holder, just like the first TD holder, can start default action if the trustor defaults on the second.
- ♦ If the trustor defaults on the first TD, the second TD holder can reinstate the first TD and start default action against the trustor. If the property's value is higher than the total amount owed on the first TD, it is a wise move for the second TD holder to start his or her own default and sale action.
- ♦ **Source of Funds** - Private individuals were for a long time the primary source of funds for junior loans, but financial deregulation of the institutional lenders, combined with income tax law changes, have led to extensive marketing of junior loans by banks and savings and loan associations.

EQUITY LOANS

The loans generally marketed as "**equity loans**" are junior loans (second mortgages) of certain amounts, usually at adjustable interest rates and amortized over fixed periods of time, such as 15 or 20 years, and secured by the borrower's equity in the property. They may be insured by FHA Title I if the money is borrowed for home improvements. Except for the adjustable interest rate feature, these institutional loans are similar to the loans made for generations by private lenders, usually negotiated by and sometimes serviced by loan brokers. These loans from private lenders are sometimes referred to in the vernacular of loan brokers as "hard money loans," although that term generally means any cash loan.

HOME EQUITY LINES OF CREDIT

Another relatively new type of junior loan being marketed by banks and S&Ls is the **"Home Equity Line Of Credit (HELOC)."** This is an extension of open credit up to certain agreed limits, secured by a second mortgage on the home. The borrower simply writes checks against the credit line and pays interest on only that amount of credit actually used (funds borrowed). Payments are made according to terms set by the lender, terms that often are subject to change by the lender from time to time.

SELLER CARRY-BACK

An owner who has a considerable equity in the home is often asked to "take back a second" as part of the purchase price of the property. This procedure enables a buyer to acquire the property with a smaller cash down payment, and it may provide the seller with a good investment opportunity for the sale proceeds. This extension of credit with assumptions of existing loans was the salvation of the real estate industry in the early 1980s when all hard money interest rates, including those for FHA and DVA loans, achieved record highs.

In several types of transactions, the seller cooperates by lending directly, offering an assumable loan, or remaining involved through a wrap-around trust deed or a land contract. The seller acts as a lender to hold or "carry back" first, second, and/or third mortgage notes from the buyer. This is an alternative to borrowing from institutional lenders.

- ♦ Seller can receive additional monthly income and might be eligible for capital gains tax deferment.
- ♦ Buyer does not need to qualify for an institutional loan or pay loan origination fees and points.
- ♦ The terms and conditions of the mortgage are subject to negotiation between the seller and buyer, subject to federally mandated imputed interest rules.

Credit extended by a seller is a type of purchase money mortgage.

SECURITY FOR THE LENDER

Security is provided by the owner's equity in the property, even though the loan secured by the property is in a secondary position.

REQUEST FOR NOTICE OF DEFAULT

A junior lienholder or other parties with interests in the property may record a **"REQUEST FOR NOTICE OF DEFAULT,"** whereby the county recorder must notify the beneficiary of a second trust deed if a default is

recorded by the first trust deed lienholder. The notice informs the junior holder so that the junior holder can reinstate the first trust deed to prevent foreclosure and thus protect the junior lien holders position.

SPLIT-RATE MORTGAGE

A new mortgage instrument--the ***SPLIT-RATE MORTGAGE***--*has been called the first true hybrid of an ARM with a fixed-rate mortgage.* It is a half-fixed, half-adjustable loan that could become attractive to both consumers and lenders.

One of the attractive features of this instrument is its anticipated ability to attract foreign dollars into American home mortgages. Because the ARM portion of the mortgage will be tied to the most popular international capital-market rate index, it is expected to attract billions in foreign capital into the American home-buying market. The market rate index is the international capital market's most commonly used money-cost yardstick--the LIBOR-- London inter-bank offering rate. The advantage of using LIBOR rather than U.S. Treasury bill rates or Federal Home Loan Bank cost-of-funds rates is that it opens the door to lenders in other parts of the world whose investments are tied to LIBOR.

Previously, mortgage borrowers have had to choose between ARMs or fixed-rate alternatives. This new split-rate mortgage offers a combination of the two. For example, a split-rate might be offered this month at a five percent fixed rate. It would not change during the life of the loan. On top of the fixed-rate coupon or note would be an adjustable-rate coupon or note, with a current yield of possibly four-and-a-half percent, tied to LIBOR. It is designed to carry a lower rate than fixed-rate conventional loans, making it attractive to borrowers.

ASSUMPTION OF AN EXISTING LOAN

A buyer may wish to take over (assume, become primarily liable for) an existing loan on a property if the terms and conditions are more attractive than new financing, such as a lower interest rate or a longer amortization.

- ♦ **Restrictions** - Many loans are not assumable or may be assumable only if the interest rate is increased (in many cases, to the current market rate) at the time of assumption. If uncertain, one should read the existing mortgage agreement and consult an attorney for clarification.
 - DVA and FHA loans are *always* assumable and maintain the same terms and conditions.
 - Some fixed rate mortgages and variable interest rate mortgages are assumable.

- ♦ **Statute and Case Law** - The California Supreme Court prohibited state chartered lenders from exercising due-on-sale clauses on their real estate loans unless the lender could prove a threat to the loan security. The federal Garn-St. Germain Act of 1982 preempted state prohibitions.
- ♦ **Liability** - In most instances, the buyer becomes primarily liable for the existing loan and the seller becomes secondarily liable. A seller may be released from all liability through a novation.
 - The Veterans Administration requires a "release of liability" to relieve the seller of primary responsibility for a DVA loan with no change in terms and conditions.
 - FHA requires a "substitution of liability" and terms and conditions will remain the same.
- ♦ **Qualifying** - Except for FHA and DVA loans, the lender may qualify the assuming party, charge an assumption fee, and renegotiate the loan at different terms and conditions.
- ♦ **Subject To** - If an existing loan contains no enforceable due-on-sale clause, the property can be sold "subject to" the existing loan, in which case the buyer's only risk is his equity.

AITD/WRAP-AROUND

An ***ALL-INCLUSIVE TRUST DEED (AITD)***, also called *wrap-around*, is a junior trust deed used to finance the sale of property, taken by a lender or carried back by the seller in an amount to cover any existing trust deeds on the property as well as any additional amount, all provided for in one junior trust deed at one interest rate.

- ♦ **Subject To** - An AITD is commonly used to preserve existing trust deeds at a favorable interest rate and avoid the costs of refinancing. It is normally used when there is no enforceable alienation clause on the existing encumbrance. (Rarely the case today except for FHA and DVA financing.) The property is purchased subject to existing loans. The seller pays off existing first trust deed payments with payments made by the buyer on the AITD.
- ♦ **Market** - The AITD is frequently used in a tight money market or when interest costs and loan charges are high. It may have more price and sales flexibility, due to the built-in financing terms.
- ♦ **Title** - Legal title is conveyed by grant deed and is insurable by a policy of title insurance.

- ♦ **Default** - If set up with a trustee handling all payments and holding the trust deed, both buyer and seller can be protected from default. If it is a purchase money transaction, deficiency judgments are not applicable. It retains favorable loan terms on existing loans in the event of foreclosure.
- ♦ **Lock-In** - An AITD can be used where an existing note contains a lock-in clause which prohibits prepayment of a loan.

Example of AITD Financing

A property is sold for \$150,000. The existing first trust deed is \$50,000 payable at \$450 per month including 10 percent interest. There is also a second trust deed on the property for \$30,000 payable at \$350 per month at 11-½ percent. The purchaser made a down payment of 10 percent of the selling price. The entire AITD of \$135,000 (\$150,000 minus \$15,000 down payment) has a monthly payment of \$1,494 including 13 percent interest.

Calculation of seller's effective interest:

AITD: \$135,000 x 13% annual interest = \$17,550

Existing loans

1st TD	\$50,000 x 10% =	\$5,000	annual
		interest	
2nd TD	\$30,000 x 11-½% =	\$3,450	annual
		interest	
Total	\$80,000	\$8,450	
\$17,550	AITD annual interest		
-8,450	Existing loan's annual interest		
\$9,100	Seller's net annual interest received		
\$135,000	AITD loan amount		
-80,000	Existing loans		
\$ 55,000	Seller's equity		

Seller's Net / Seller's Equity = \$9,100 / \$55,000 = 16.545% = 16.55% = effective interest

Seller makes a profit on the existing loans since purchaser is paying 13 percent on the entire AITD, which includes existing loans payable at lesser interest rates. Seller receives an additional three percent interest on the first trust deed of \$50,000 and an additional one-and-a-half

percent on the second trust deed of \$30,000 and the full 13 percent on the seller's equity portion of \$55,000.

ADVANTAGES TO BUYER AND SELLER

Relatively low down payments and below market interest rates are frequently offered with an AITD. In addition:

- ♦ The purchaser may be able to obtain a property for which qualifying may otherwise have been difficult.
- ♦ It may be possible to acquire a larger property with a lower down payment (utilizing more leverage.)
- ♦ One monthly installment payment is required rather than payments on separate notes.
- ♦ When the seller becomes the lender, the parties are not subject to the stringent controls of institutional lenders.
- ♦ The seller's (lender's) effective interest yield will be very attractive.

PROCEDURES

Setting up an AITD could include:

- ♦ Renegotiating or paying off any existing loans which restrict alienation.
- ♦ Constructing a realistic payment schedule to cover outstanding balances, periodic payments, and any balloon payments which may pertain to existing loans.
- ♦ Deciding who will administer and pay for collection procedures. Determining what conditions define default.
- ♦ Having an attorney compose the necessary documents and agreements in terms acceptable to the title insurance company insuring the property and acting as trustee.

PACKAGE TRUST DEED

A **PACKAGE TRUST DEED OR PACKAGE LOAN** is a type of self-amortizing loan that takes the fixed-rate deed of trust one step further. It is not only secured by the real property, but it includes some of the appliances and other items that are a part of the structure to be financed.

Items often included in the package deed of trust are stoves, ovens, dishwashers, carpet, heating, and air conditioning. One reason to include such easily removed items in a deed of trust is that the lender is better able to protect the investment. The property is more sellable with these items in place. An important advantage for the borrower is that he can include the cost of these items in the deed of trust and, therefore, be able to budget their cost. This instrument is frequently used by institutions licensed as personal property brokers, such as finance companies.

☞ *A loan used in home financing that is secured by a combination of real property, improvements, movable equipment and/or appliances.*

OPEN-END TRUST DEED

As the name implies, the **OPEN-END DEED OF TRUST** *has no due date*. The balance is usually not paid off and can be as little as one dollar. Thus, the mortgage is still alive and the lender can lend funds without having to start the procedures of a new loan; the collateral for the original loan is still used for the new funds. This type of loan is used primarily to finance agriculture in rural areas, where the lenders are quite familiar with the borrowers and their financial capabilities. It has some use in today's real estate market. Additionally, certain deeds of trust with stated maturities have open-end provisions which allow for additional advances during the life of the trust.

☞ *An open-end trust deed allows additional amounts of money to be lent to borrower in the future under the same terms and conditions as the existing trust deed.*

BLANKET TRUST DEED (WITH RELEASE CLAUSE)

A **BLANKET DEED OF TRUST** *with release clause is normally used for financing the purchase and development of land or subdivisions*. Under the blanket deed of trust, the developer has the opportunity to include more than one piece of property, usually subdivision lots, with the ability to release a lot from the mortgage as it is sold. This means, for example, if a developer has a subdivision of 100 lots financed under a blanket deed of trust with release clause, as the developer sells one of the lots, the developer pays off an amount of at least 1/100th of the total amount. It may be as much as 110 to 120 percent of that fractional figure, depending upon lender requirements. The lender will release the parcel or lot from the mortgage, thus giving the person purchasing the lot clear

title. Without the release clause capability, the developer would have to sell all 100 lots before clear title could be issued for any of the lots.

- ♦ **Effect** - As specified portions of the loan are paid, specific parcels are released from the blanket encumbrance, if a release clause is in existence. A deed of partial reconveyance is used to affect this.
- ♦ **Use in Subdivisions** - A responsible land promoter will usually secure a special release clause from the lender if the separate subdivided parcels encumbered under the blanket trust deed were originally part of one large parcel. This protects individual smaller parcel buyers in case of a defaulting developer and/or promoter.
- ♦ **Income Tax liens** - Involuntary blanket encumbrances may be placed on properties of an individual by the federal government for nonpayment of income tax.

☞ A blanket trust deed is one loan instrument covering two or more parcels. Borrower may pledge more than one parcel as security for a loan.

LAND CONTRACT/INSTALLMENT SALES CONTRACT

A **LAND CONTRACT** is "An agreement wherein one party (the seller) agrees to convey title to real property to another party (the purchaser), upon the satisfaction of specified conditions set forth in the contract."

They are also called **Conditional Sales Contract, Installment Sales Contract, Contract For Deed, Or Contract To Sell**. The essential characteristic is that the seller retains title to property to the end of the contract term. Buyer receives possession at inception, but not a deed.

A land contract is not a true mortgage. It is mentioned in this section only because it is used in some types of transactions. As its name implies, it is a contract, and if the purchaser meets all of the provisions of the contract, he may sometime in the future get a deed to the property. An agreement of sale has been used in the past to sell recreational land where the developer, due to previous financing, cannot give clear title to the property until the previous financing is paid and released. It is also used to sell low-quality rental property to the present tenant.

There are some definite drawbacks to this type of financing, including the following:

- ♦ The installment sales contract, if not recorded, would allow a less-than-honest developer to sell a piece of property more than once.
- ♦ A title policy may not be secured on the property.
- ♦ Most severely, even though the purchaser makes all of the payments in good faith, he or she may not be able to receive clear title due to insanity of the seller or a death, divorce, or bankruptcy concerning the seller or a member of his or her family.

Recognizing all of the possible dangers to a purchase of recreational or resort-type lots, the federal government, through HUD, established the Office of Interstate Land Sales Registration with the passage of the Interstate Land Sales Full Disclosure Act in 1969. The purpose of the act was to police the sale of land by developers in subdivisions of 50 lots or more for lots less than five acres. Under the act, each developer must prepare and submit an Office of Interstate Land Sales Property Report Form. The developer must supply this report to the prospective purchaser before any contracts are signed. If the purchaser does not receive a copy of the report prior to the time he enters into a contract with the seller, the purchaser may terminate the contract by notice to the seller. The purchaser must sign a statement that he has received a copy of the property report.

CHARACTERISTICS OF LAND SALES CONTRACT

- ♦ **Parties** - The parties to a land contract are **vendor** (owner or seller; extender of credit) and **vendee** (purchaser or borrower, "equitable owner.")
- ♦ **Resale** - Either party may transfer the property.
 - The vendor may sell the title but must assign the contract.
 - Vendee may assign or sell the property unless the contract prohibits it. Prepayment or sale which may prepay the loan can be prohibited only up to 12 months from the date of contract.
- ♦ **Encumbrances** - Both parties may encumber the property, within limits.

If a contract is unrecorded, the vendor may encumber the title subject to the following:

 - if all encumbrances (existing and new) will exceed balance due on the contract, written consent of the vendee must be obtained.

- Payments on a trust deed cannot exceed the payment due from the vendee on the land contract unless vendee consents in writing.
 - Payments received from the vendee must first be applied to any payments due on existing trust deeds.
 - The vendee may encumber the equitable interest but cannot use legal title as security, and may homestead the equitable interest.
- ♦ **Reasons for Use** - Land contracts are used by the California Department of Veterans Affairs in Cal-Vet purchases. Other circumstances for using them might include:
 - When a buyer does not have sufficient down payment or credit for a traditional loan.
 - During a tight money market where traditional loans are hard to get.
 - When seller does not wish to give legal title or buyer does not wish to receive legal title.
 - To retain favorable trust deed loans existing on a property which vendor would regain in the event of repossession.
 - ♦ **Safeguards** - Both vendor and vendee should be alert to the possibility of the lender's enforcement of a due-on-sale clause, the requirement of a disclosure statement, and the advisability of a review of the transaction by an attorney.

DISADVANTAGES

Because title is not conveyed by a land contract in the usual manner, there are a number of possible complications.

- ♦ If the vendee defaults and refuses to move or pay, the vendor must file court action.
- ♦ Court action is required for the vendor to regain clear title when the contract is recorded and the buyer defaults and refuses to record a release.
- ♦ Title may be subject to mechanics or other liens.
- ♦ The contract may prohibit assignment by the vendee.
- ♦ The vendee's equitable interest is not attractive security for loans.
- ♦ The vendee might receive defective title or no title at all upon conclusion of the contract.

- ♦ The vendee may be faced with expensive court proceedings to acquire title if the vendor dies or becomes incompetent or bankrupt.

REMEDIES FOR DEFAULT

If the vendee defaults, the vendor may:

- ♦ Sue for specific performance.
- ♦ Sue for damages.
- ♦ Agree to rescind.
- ♦ Bring "**quiet title action**" in court if title is clouded.
- ♦ Attempt to declare forfeiture and retain money paid as liquidated damages. (Court allows reasonable damages only.)

GRADUATED PAYMENT MORTGAGE (FHA 245)

A **GRADUATED PAYMENT MORTGAGE LOAN** is a fixed-rate loan on which the monthly payments begin at a level lower than that of a level payment fixed-rate loan. During a period--the length of which is fixed at loan origination -- (the graduation period), the monthly payment amount gradually rises to a level sufficient to amortize the remaining principal balance over the remaining term of the loan.

A GPM provides that monthly payments are initially lower in the first five to 10 years with a gradual annual increase to a predetermined point, after which they remain constant.

The graduation periods, the rate of increase, and the interest rate are fixed when the loan originates.

Available only to owner-occupants for single-family dwellings, and can be assumed.

These programs are designed primarily for younger buyers whose incomes are expected to rise as the monthly payments increase.

FIVE DIFFERENT GPM PLANS

Percentage of monthly payment During the first
increase

Plan I	2.5% each year	5 years
Plan II	5% each year	5 years
Plan III	7.5% each year	5 years
Plan IV	2% each year	10 years
Plan V	3% each year	10 years

While five optional plans exist, the most popular one is a five-year plan-Plan III. Initial payments are not large enough to cover all the interest due, so the shortfall is added to principal, with consequent negative amortization. Monthly payment amounts are increased 7.5 percent per year, with the effect that positive amortization begins to appear during the fifth year, after which the payments are increased to the point that full amortization occurs during the subsequent 25 years. All GPMs, whether FHA or conventional, follow this pattern.

These loans have not been used for some time, particularly during periods when 30-year, fixed rate loans are easily available.

RESIDENTIAL LEASE WITH OPTION TO PURCHASE AGREEMENTS

The lease with option to purchase agreement is a procedure combines the lease with an option to buy rather than a contract to buy.

- ♦ A deposit is not necessarily made.
- ♦ The lessee has the right to exercise the option to purchase for as long as the lease is in effect.

This device can be used when financing is difficult to obtain. It is utilized to take advantage of the possibility that better financing may be available at a later date.

The lease agreement and sales contract are drawn up simultaneously, with an option for lessee to exercise the right to purchase. The sales price is specified, and an agreement to purchase on or before some stated date. The "locked-in" purchase price benefits the lessee/buyer.

☞ The lessor has the right to terminate the option if the lease agreement is breached.

SALE-LEASEBACK

This arrangement between seller-lessee and buyer-lessor releases capital which the seller has tied up in property at an old basis with no depreciation left. The seller is normally a business which owns the premises and continues to occupy them as lessee after the sale.

- ♦ The seller can retain an ideally-suited property for use of the business.
- ♦ The seller-lessee can deduct full rental. (Advantage over borrowing on equity and deducting interest only.)
- ♦ The buyer-lessor gets an ideal tenant who manages the property, as well as depreciation benefits and appreciation potential.

BUYDOWNS

With a buydown the effective interest rate is reduced or "bought down" during the initial term of the loan for the borrower by contributions made by other parties, e.g., the builder-developer or seller. The third party, in effect, pays for part of the interest in advance.

- ♦ The buydown cash is usually deposited into a non-revocable savings account with an automatic payment to the lender.
- ♦ The lower interest rate usually lasts two to three years.
- ♦ Costs of the buydown may be passed to the buyer-borrower in the form of a higher sales price.

Some S&Ls now offer borrowers an opportunity to buy down the terms of an adjustable rate mortgage:

- ♦ **Start rate** - The borrower may be permitted to reduce the starting interest rate by the payment of a certain fee. Example: The lender may reduce the starting interest rate by 1/8 percent for a consideration of 1/4 of a point.
- ♦ **Stated cap** - The lender may be willing to reduce the stated interest rate cap. Example: Reduce the rate cap by 1/8 percent for a consideration of 1/4 of a point.
- ♦ **Margin** - The lender may reduce the interest margin. Example: A reduction of 1/8 percent for a consideration of 3/4 of a point.

SHARED APPRECIATION MORTGAGE

A **SHARED APPRECIATION MORTGAGE** is a first mortgage loan offered by a lender at a below-market interest rate in exchange for a percentage share in the future gain of the property's value. Common characteristics include a fixed interest rate, and a discounted rate in exchange for equity share. The borrower makes no guarantee on the amount of appreciation in property value.

- ♦ Ratios may vary for individual lenders.
- ♦ Most common is a 33.3 percent reduction in interest rate for a 33.3 percent share of the increased value of the property upon its sale or at a predetermined date.
- ♦ The lender may be required to set a maximum "call date" or "balloon date," after which the lender may enter into a new SAM loan.
- ♦ **Advantages** - More borrowers are able to qualify due to the lower interest rate, lower payments, and lower down payment. During an inflationary period, the lender's yield is greater than on a conventional loan, and there may be tax advantages due to the deferred yield.

EQUITY PARTICIPATION PLAN

An **EQUITY PARTICIPATION PLAN** involves an owner/occupant and an investor who share the cost of ownership, equity, and tax benefits. A common application is that parents assist a son or daughter to acquire a home by putting up the cash for a down payment in exchange for an equity position in the property. Also, an employer might join with a transferred employee in buying a house in a high cost area to facilitate the transfer. The employee would then be given an option to buy out the employer at a time to be determined.

REVERSE MORTGAGE

A **REVERSE MORTGAGE (REVERSE ANNUITY MORTGAGE)** is a loan which utilizes the equity in a homeowner's residence to make payments on the property or to provide living expenses for persons retired with fixed retirement or pension incomes.

The lender makes the payments on the property or provides cash for the owner from the equity for a fixed period, until a specified loan-to-value ratio is reached or until the homeowner dies.

The lender charges interest for the use of the money.

Upon sale of the property, the amount paid through the annuity will be repaid from the equity in the property.

This may be especially attractive to an elderly homeowner, as it eliminates the need to make monthly payments on the residence or provides cash for living expenses.

Reverse mortgages are available only for those 62 or older. The home must be free and clear, or have a low existing loan. The program is for single-family dwellings only, except for FHA approved condos. Neither Fannie Mae nor FHA makes direct reverse loans. Instead, approved lenders make the loans with Fannie Mae and FHA backing.

TWO-STEP MORTGAGE

The purpose of a ***TWO-STEP MORTGAGE*** is to allow home buyers to qualify for a loan based on lower interest rates and therefore lower payments. You will find that the two-step mortgage has many of the features of "loans amortized for 30 years but due in five or seven years" discussed in previous section of balloon mortgages.

The chief advantage of the two-step over a balloon mortgage or the previously discussed "amortized for 30 years, but due in five or seven years" loan is that borrowers aren't forced to move or refinance—they simply endure a one-time adjustment to the interest rate.

CHARACTERISTICS OF TWO-STEP MORTGAGE

- ♦ A fixed rate of interest is charged for the initial period, usually seven percent, based on 30-year payment schedules.
- ♦ An automatic conversion following the initial period may be another fixed rate years, that is lower than the standard for 30-year, fixed rate loans.
- ♦ Amortization at the then-prevailing rate. It could be adjustable but with a lifetime interest ceiling set at the time of the loan, at no additional cost. The conversion feature assures the borrower that the otherwise large balloon due in seven years will come from the same lender, only at a different rate. Stated differently, the two-step guarantees fixed rate financing for the entire loan term without having to come up with a sizable balloon payment.

- ♦ Because they qualify for purchase by FNMA in the secondary market (discussed in earlier chapter), loan amounts vary according to the current limits set by FNMA.

BIWEEKLY FIXED RATE LOANS

BIWEEKLY FIXED RATE LOANS shorten the life of the loan because the principal is decreased faster. Borrowers make 26 rather than 12 payments per year. Making a payment every two weeks means that the payment is applied to decrease the unpaid balance on the loan every two weeks. Since interest can only be charged on the unpaid interest due, then the remaining amount directly reduces the principal.

How much faster is a loan paid off using biweekly instead of monthly payments? A rule of thumb is that it is *one-third faster*--a traditional 30-year monthly amortized loan can be paid off in about 21 years using biweekly payments. If your lender does not provide the opportunity, certain facilitating companies can set up this procedure for you, with fees in the range of \$500.00.

Biweekly payment programs are approved by Fannie Mae and Freddie Mac, thus there is a secondary market for these loans. Some borrowers prefer the biweekly payment loans because of the savings in interest costs and faster loan payoff.

For borrowers who do not wish to enter into a formal biweekly agreement there are solutions. For example, the borrower can accomplish similar results, though with a slightly longer payoff period, by making a 13th payment toward principal reduction each year. Or the borrower could increase each regular installment by one-twelfth of the principal amount of the payment. Of course, these prepayments can be accomplished only if they are not prohibited under the terms of the promissory note. If the borrower makes the 13th monthly payment, he/she must make sure the lender is aware of its purpose--*principal reduction only*.

🔗 INTERNET WEB LINKS

www.bea.doc.gov	Bureau of Economic
www.bls.gov	Bureau of Labor Statistics
www.census.gov	US Census Bureau
www.federalreserve.gov	Federal Reserve

CHAPTER 9 QUIZ

1. Adjustable rate mortgages offered by various lenders at any given time may differ in:
 - A. Interest rate caps
 - B. The index used
 - C. The adjustment period
 - D. All of the above
2. Reasons for using alternative financing do not normally include:
 - A Low interest rates and high availability of money
 - B California's heavy dependency on out-of-state mortgage funds
 - C Tight money market
 - D A buyer who is unable to qualify for traditional financing
3. Negative amortization means:
 - A The loan is never amortized
 - B The loan balance decreases with each monthly payment
 - C The loan balance does not change with each money payment
 - D The loan balance increases with each money payment
4. An AITD is an:
 - A All interest trust deed
 - B Alternative investment trust deed
 - C Attenuated insurance trust deed
 - D All inclusive trust deed
5. The maximum interest rate that a lender can charge under an ARM is called the
 - A. Cap
 - B. Margin
 - C. Term
 - D. Adjustment
6. In an ARM loan, when the initial interest rate is abnormally low It is known as the _____ rate.
 - A. Index
 - B. Teaser
 - C. Capped

- D. Basement
7. Under an ARM loan, the distance between the actual rate paid by the borrower and the index is called the
- A. Adjustment
 - B. Cap
 - C. Term
 - D. Margin
8. An AITD:
- A Is subordinate to the underlying existing loan(s)
 - B Is a junior trust deed
 - C Can be a purchase money transaction
 - D. All of the above
9. The use of an owner's equity to pay scheduled payments is called:
- A Reverse annual mortgage
 - B Revised annual mortgage
 - C Reverse annuity money
 - D. Reverse annuity mortgage
10. How much faster is a loan paid off using biweekly instead of monthly payments on a 30 years loan?
- A 1/5
 - B 1/4
 - C 1/3
 - D. 1/2

*Chapter 9 Answers: 1-D, 2-B, 3-D, 4-D, 5-A, 6-B, 7-D, 8-D, 9-D,
10-C*

CHAPTER 10: REGULATION OF LOAN BROKERAGE



PREVIEW

In this chapter, we discuss the various regulation of loan brokerage. We will learn how hard money loans differ from other loans, as well as who makes these loans and why. We will also learn the latest SAFE Act, the requirements of Article 1, 5, 6 and 7 of the real estate law.

SECURE AND FAIR ENFORCEMENT FOR MORTGAGE LICENSING ACT (SAFE ACT)

The **SECURE AND FAIR ENFORCEMENT FOR MORTGAGE LICENSING ACT (SAFE ACT)** was enacted on July 30, 2008, and mandates a nationwide licensing and registration system for residential mortgage loan originators (MLOs).

The SAFE Act prohibits individuals from engaging in the business of a residential mortgage loan originator without first obtaining and maintaining annually:

- For individuals who are employees of covered financial institution, registration as a registered mortgage loan originator and a unique identifier (federal registration), or
- For all other individuals, a state license and registration as a state-licensed mortgage loan originator, and a unique identifier (state licensing/registration).

The SAFE Act requires that federal registration and state licensing and registration be accomplished through the same online registration system, the ***NATIONWIDE MORTGAGE LICENSING SYSTEM (NMLS) and Registry***. The objectives of the SAFE Act include aggregating and improving the flow of information to and between regulators; providing increased accountability and tracking of MLOs; enhancing consumer protections; supporting anti-fraud measures; and providing consumers with easily accessible information at no charge regarding the employment history of and publicly adjudicated disciplinary and enforcement actions against MLOs.

The SAFE Act requires state-licensed MLOs to pass a written qualified test, to complete pre-licensure education courses, and to take annual continuing education courses. The SAFE Act also requires all MLOs to submit fingerprints to the Nationwide Mortgage Licensing System (NMLS) for submission to the FBI for a criminal background check; and state-licensed MLOs to provide authorization for NMLS to obtain an independent credit report.

MLO PRELICENSING EDUCATION REQUIREMENTS

Mortgage Loan Originators must:

1. Provide fingerprints for an FBI criminal history background check
2. Provide authorization for NMLS&R to obtain a credit report
3. Input and maintain their personal Mortgage Loan Originator record in NMLS&R as their license in each state in which they wish to conduct loan origination activity
4. Pass a 125 question national mortgage test, which is the Uniform State Test (UST). All states require the UST national test, and a few states still require an additional state-specific component.
5. Take 20 hours of pre-licensure education courses approved by NMLS&R. The education must include:
 - o 3 hours of federal law and regulations
 - o 3 hours of ethics, which must include fraud, consumer protection, and fair lending
 - o 2 hours of standards on non-traditional mortgage lending
 - o 12 hours of additional NMLS approved elective education

The test includes:

1. Ethics,
2. Federal law and regulation,
3. Generic state law and regulation, and

4. Federal and state law and regulation pertaining to fraud, consumer protection, nontraditional mortgages, and fair lending.

All state-licensed Mortgage Loan Originators must meet the following standards:

- a. Never had a loan originator license revoked,
- b. Has had no felonies in the past seven years,
- c. Never had a felony involving fraud, dishonesty, breach of trust or money laundering,
- d. Demonstrates financial responsibility and general financial fitness, and
- e. Scores 75% or better on a national test created by NMLS.

MLO CONTINUING EDUCATION (8 HOURS ANNUALLY)

Take 8 hours of continuing education annually. The education must include:

- a. 3 hours of federal law and regulations,
- b. 3 hours of ethics, which must include fraud, consumer protection, and fair lending,
- c. 2 hours of standards on non-traditional mortgage lending.

In addition to the **eight hours of continuing education**, licensure must be maintained through the NMLS by **payment of required annual fees**.

ARTICLE 1, REAL ESTATE LAW-BROKER LICENSE REQUIRED

Article 1, Chapter 3 of the California Real Estate law, "Real Estate Regulations" defines the activities which require that a person be licensed as a real estate broker (or be a licensed real estate salesperson in the employ of a broker.) In some of these activities the person is not dealing in real estate, but is dealing in "real estate paper"--financing instruments (promissory notes) secured by security instruments carrying liens on real property (mortgages, trust deeds, and land contracts.)

DEFINITIONS

- ♦ **Loan Brokers** - A real estate broker's license is required for a person who, in expectation of compensation, solicits borrowers or lenders for or negotiates or collects payments or performs services for, borrowers or lenders or note owners, in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.
- ♦ **Agent** - A broker's license is also required of a person who, for compensation, acts as an agent in the sale, purchase, or exchange of existing "real estate paper."
- ♦ **Principal** - Article 1 also defines "broker" as including any person who engages as a principal "in the business" of buying, selling, or exchanging with the "public" real property sales contracts, or promissory notes secured by liens on real property (real estate paper.)
- ♦ **In the Business** - The term "in the business" is specifically defined as it applies in this law as anyone who:
 - ♦ Acquires for resale to the public (and not as an investment) eight or more such items of real estate paper during a calendar year or
 - ♦ Sells or exchanges eight or more items of such paper with the public during a calendar year.

Any such person (in any combination of such transactions) must be a broker or deal through a broker.

☞ For complete details of Article 1, visit www.leginfo.ca.gov (California Business and Professions Code)

ARTICLE 5-TRANSACTIONS IN TRUST DEEDS AND SALES CONTRACTS

Article 5, "Transactions in Trust Deeds and Real Property Sales Contracts," is applicable to real estate licensees engaged in the business of brokering mortgage loans or acting as agents in the sale, purchase or exchange of existing loans.

☞ The purpose of Article 5 is to curb broker abuses in arranging loans.

"Mortgage loan broker," as defined in Section 10232, is a broker who meets the threshold criteria:

- ♦ Negotiates loans or sales of loans at a rate of *20 or more per year* in an aggregate amount of more than *two million dollars (\$2,000,000.)*
- ♦ Makes collections of payments in one year in an aggregate amount of five hundred thousand dollars (\$500,000.)

SELF-DEALING BROKER

A real estate broker who proposes to solicit and accept funds to be applied to a purchase or loan transaction in which the broker will directly or indirectly obtain the use or benefit of the funds, other than commissions for services, is defined as a "self-dealing" broker (Section 10231.2.)

- ♦ **Application** - The broker who negotiates a real estate loan or the sale of an existing note and trust deed must provide the lender or purchaser with a specific disclosure statement that describes the note and trust deed being funded or offered for sale, details about the borrower, and other pertinent information.

DISCLOSURE REQUIREMENTS

The disclosure statement which previously was provided to only a relatively few lenders and purchasers of financing instruments is now to be given to practically all non-Institutional lenders and note purchasers.

- ♦ All brokers must provide the **Lender/Purchaser Disclosure Statement** (RE 851) (see Form 10-1) to lenders and note purchasers except to those institutions specifically exempt (banks, savings and loans, insurance companies, pension trusts, FNMA, FHLMC, etc..)
- ♦ **Timing** - As early as practical before accepting any funds. (A self-dealing broker must submit the form 24 hours before accepting funds.)
- ♦ **Signatures** - The form must be signed by the prospective lender or purchaser, and by the broker.
- ♦ **Customer Copy** - A copy must be provided to the lender or purchaser.
- ♦ **Retention** - The broker must retain a copy for four years.
- ♦ **State Filing** - A "self-dealing" broker must submit to the Department of Real Estate a copy of the disclosure statement and a concurrent statement that the submittal is pursuant to §10231.2.

- ♦ **Timing** - The disclosure statement must be submitted to DRE *prior to* making any presentation to the lender or purchaser.

DISCLOSURE TO LENDER

"(a) If the real estate broker is ... negotiating a loan to be secured by a lien on real property or on a business opportunity, the statement required to be given to the prospective lender shall include, but shall not necessarily be limited to, the following information:

- ♦ **Property Identification** - Address or other means of identification.
- ♦ **Market Value** - Estimated fair market value of the securing property, and if the broker is relying on an appraisal... the date that the appraisal was made and the name of the person who made the appraisal.
- ♦ **Improvements** - Age, size, type of construction and a description of improvements to the property.
- ♦ **Borrowers** - Identity, occupation, employment, income, and credit data about the prospective borrower or borrowers as represented to the broker.
- ♦ **Terms** - Terms of the promissory note to be given to the lender.
- ♦ **Liens** - Pertinent information concerning all liens against the securing property and, to the extent of actual knowledge of the broker, pertinent information about other loans that the borrower expects or anticipates will result in a lien being recorded against the property securing the promissory note to be created in favor of the prospective lender.
- ♦ **Loan Servicing** - Provisions for servicing of the loan, including disposition of the late charge and prepayment penalty fees.
- ♦ **Joint Parties** - Detailed information concerning any joint beneficiaries or obliges.
- ♦ **Self-Dealing Broker** - If the solicitation is subject to the provisions of Section 10231.2 [self dealing], a detailed statement of the intended use of the funds and benefits to the broker.

DISCLOSURE TO PURCHASER

(b) If the real estate broker is... negotiating the sale of a real property sales contract or promissory note secured directly or collaterally by a lien on real property, the statement required to be given to the prospective purchaser ... shall include, but shall not necessarily be limited to, the following information:

- ♦ **Property Identification** - Address or other means of identification of the real property that is the security for the tractor's or vendee's obligation.
- ♦ **Market Value** - Estimated fair market value of the real property, and if the broker is relying on an appraisal in estimating the fair market value, the date that the appraisal was made and the name and employment of the person who made the appraisal.
- ♦ **Improvements** - Age, size, type of construction and description of improvements to the real property if known by the broker.
- ♦ **Trustor or Vendee** - Information available to the broker relative to the ability of the trustor or vendee to meet his or her contractual obligations under the note or contract including the trustor's or vendee's payment history under the note or contract.
- ♦ **Terms** - Terms of the contract or note including principal balance owed. Provisions for servicing of the note or contract, if any, including disposition of late charge, prepayment penalty or other fees or charges paid by the trustor or vendee.
- ♦ **Joint Parties** - Detailed information concerning any proposed arrangement under which the prospective purchaser along with persons not otherwise associated with him or her will be joint beneficiaries or obligees.
- ♦ **Dealer's Role** - A statement as to whether the dealer is acting as a principal or as an agent in the transaction with the prospective purchaser.

EXEMPTIONS FROM COVERAGE

The provisions of Article 5 do not apply to the following.

- ♦ **Broker Transactions in Connection With Sales** - The provisions of Article 5 do not apply to negotiation of a loan by or for a real estate

broker in connection with a sale or exchange of real property where the real estate broker acted as an agent.

Article 5 also does not apply to the sale or exchange by or for the broker of a promissory note created to finance the sale or exchange where the broker acted as an agent for one of the parties. This exemption applies regardless of the relationship between the time of the sale or exchange of the promissory note and the time of the sale or exchange of the property.

- ♦ **Broker Direct Benefit** - The above exemptions do not apply to negotiations of loans and sales or exchanges of promissory notes in connection with the financing of a real property sale or exchange transaction in which the broker, as a party, had a direct or indirect financial interest.

Note: Section 10230(a) covers the exemption in connection with a broker sale or exchange, but paragraph (b) of Section 10230 removes transactions from the exemption where the broker had a financial interest (was a principal rather than an agent.)

RESTRICTIONS ON RETENTION OF LOAN FUNDS

A person engaged in any of the activities listed below, either as an agent or a principal, shall not retain funds payable under the terms of a real property secured promissory note for more than 60 days, except with a written agreement with the purchaser or lender. (Business and Professions Code 10231.1) The following are covered by this restriction.

- ♦ **Soliciting (Servicing)** - Soliciting borrowers or lenders for loans or negotiating loans or collecting payments or performing services for borrowers, lenders or note owners in connection with loans secured by (directly or collaterally) by liens on real property or business opportunities.
- ♦ **Selling/Buying** - Selling, offering to sell, buying, offering to buy, exchanging or offering to exchange a lien secured by real property or a business opportunity and performing services for the holders thereof.
- ♦ **Acting as a Principal** - Acting as a principal in the business of buying from, selling to, or exchanging with the public, real property sales contracts or promissory notes secured directly or collaterally by liens on real estate or making agreements with the public for the collection of payments or for the performance of services in connection with sales Contracts or promissory notes secured by real property.

BROKER BENEFITS

- ♦ **Submission to the DRE when Broker Benefits** - When a real estate broker, who acts within the scope of the above, proposes or causes the solicitation and acceptance of funds to be applied to the purchase of a loan transaction where the broker will directly benefit (other than commission and costs), the broker must first submit a statement to the Department of Real Estate. The statement shall include:
 - a copy of the statement given to the person solicited,
 - that it is being submitted pursuant to Business and Professions Code 10231.2.

STATEMENT TO PERSON SOLICITED WHEN BROKER BENEFITS

When the broker benefits from a loan transaction, the broker will deliver, or cause to be delivered, a completed statement not less than 24 hours before (whichever is earlier) either the acceptance of any funds or the execution of an agreement to obligate the person to make the loan or purchase. The statement must be signed by the prospective lender or purchaser and by the broker (or a salesperson on the broker's behalf.) The broker must keep a copy of the statement for four years. The contents of the statement shall include, but is not limited to:

1. Address or identification of the property securing the borrower's obligation.
2. Estimated fair market value. If the broker relies on an appraisal, the date of the appraisal and who made it for whom.
3. Age, size, type of construction and a description of the improvements if contained in the appraisal or as represented by the prospective borrower.
4. Identity, occupation, employment, income and credit data of prospective borrower(s) as represented to the broker by the borrower(s.)
5. The terms by the promissory note to be given to the lender.
6. Information concerning all encumbrances that are liens against the securing property as known by the broker and pertinent information about other loans the borrower expects will result in being recorded against the property.
7. Any provisions for servicing the loan including disposition of late charges and prepayment penalty fees.
8. Information concerning any arrangement under which the prospective lender along with persons associated with him or her will be joint beneficiaries or obligees.

9. If the solicitation is subject to the provisions of Section 10231.2, which involves collection of advance fees, there must be a detailed statement of the intended use and disposition of funds solicited including any direct or indirect benefits to the broker.
If the broker is selling existing obligations secured by real estate as either a principal or as an agent, the following must be included:
10. Ability of the trustor or vendee to make his or her payments including the trustors or vendees payment history
11. A statement as to whether or not the dealer is acting as a principal or as an agent in the transaction.

EXEMPTION FROM STATEMENTS TO DRE AND PERSONS SOLICITED

Disclosure Statements do not apply to the offering of a security pursuant to Article 6 (covered later in this chapter) or transactions subject to the Corporate Securities Law.

Application to Corporate Brokers

The disclosures apply to funds which are intended for the direct or indirect use or benefit of any officer, director or stockholder (holding more than 10 percent interest in the corporation) when the funds were solicited by the corporate real estate broker.

SOLICITATION AND ACCEPTANCE OF FUNDS OTHER THAN FOR SERVICES SPECIFIED STATEMENT AND ITS USE

- ♦ **10231.2(a.)** A real estate broker who, through express or implied representations that the broker or salesperson acting on the broker's behalf are engaging in acts for which a real estate license is required by subdivision (d) or (e) of Section 10131, proposes to solicit and accept funds, or to cause the solicitation and acceptance of funds, to be applied to a purchase or loan transaction in which the broker will directly or indirectly obtain the use or benefit of the funds other than for commissions, fees and costs and expenses as provided by law for the broker's services as an agent, shall, prior to the making of any representation, solicitation or presentation of the statement described in subdivision (b), submit the following to the Department of Real Estate:
 - A true copy of the statement described in subdivision (b) complete except for the signature of the prospective lender or purchaser.
 - A statement that the submittal is being made to the department pursuant to Section 10231.2.

ADVERTISING BY LOAN BROKERS

A "mortgage loan broker" who meets the threshold requirements (20 or more loans totaling \$2 million per year) must submit a copy of all related advertising to the Department of Real Estate for clearance.

- ♦ **Advertising** includes newspapers, circular form letters, brochures or similar publications, signs, displays, radio broadcast or telecasts which concern:
 - Use of terms, rates, conditions or the amount of any loan or sale.
 - The security, solvency or stability of any person carrying on the activities of the loan brokerage activities.
- ♦ Not Considered Advertising
 - Information distributed to other brokers and persons who the broker had previously acted for as an agent.
 - Information restricted to the identification and description of terms of loans, mortgages, deeds of trust and land contracts offered for funding or purchase through the loan broker.
 - Advertising a real property security (Article 6 of the real estate law.)
- ♦ **Premiums** - A broker may not advertise a premium or gift to induce a borrower, lender or purchaser.
- ♦ **Different Yield** - A broker may not advertise a yield different than the rate on the note unless the advertisement states the rate on the note and the discount from face value for which the loan can be purchased.
- ♦ **Submission of Advertising** - The submission of advertising for approval to the Department of Real Estate was formerly mandatory. Business and Professions Code Section 10232.1 has changed "shall "to "may" which makes the submission voluntary.

☞ When submitted, a true copy shall be accompanied by a fee not to exceed \$40. The approval is for five years. If advertising submitted for approval is not given within 15 calendar days, the proposed advertising shall be considered approved.
- ♦ **Advertising Identification** - The Department of Real Estate assigns an identifying number to each advertisement submitted for approval.

Brokers who use visual advertisements will include the number in their advertisements.

- ♦ **Advertising Criteria** - The commissioner may prevent or halt the publication of false, misleading or deceptive advertising. Commissioner's Regulation 2848 sets forth examples of false, misleading and deceptive advertising.

BROKER ADVANCING OTHER THAN OBLIGOR'S FUNDS

If, in servicing a real property secured loan the broker pays funds to the lender other than the funds of the obligor, the broker must give written notice of this fact to the lender or owner of the note. The notice must be given within 10 days of making any such payment and include the date and amount of payment, the name of the person to whom payment was made, the source of funds and the reason for making the payment. (Business and Professions Code 10233.1)

Note: Prior to this requirement, some mortgage brokers would hide from the lender the fact that a borrower was in default while trying to get the borrower current.

MORTGAGE LENDER / INVESTOR DISCLOSURE STATEMENT

In addition to the borrower disclosure statements, which are required in loan transactions other than federally related loans, there is a lender/investor disclosure statement. This statement is limited to:

1. private lenders
2. small pension funds (less than \$15,000,000 in assets)
3. credit unions

RECORDING OF TRUST DEEDS

If a real estate broker negotiates a loan secured by a trust deed on real estate, the broker must record the trust deed (naming the lender as beneficiary) prior to the release of any funds, unless the lender provides a written authorization for a prior release of funds.

If the funds are released on the written authorization of the lender prior to recording, the broker shall either record the trust deed within 10 days of release of funds or deliver the trust deed to the lender with a written recommendation that it be immediately recorded.

RECORDING OF ASSIGNMENTS

☞ *When a real estate broker sells or otherwise arranges a transfer of an existing trust deed or sales contract secured by real estate, the broker shall record the assignment naming the assignee as purchaser.*

Recording must be within 10 working days after the seller receives funds from escrow or the buyer for the assignment. Alternatively the broker may deliver the real property sales contract or trust deed to the purchaser with a written recommendation that it be immediately recorded. (Business and Professions Code 10234)

ANNUAL REPORTS

A "**mortgage loan broker**" must file **annual** reports with the DRE, which must include a review by a licensed California independent public accountant.

For complete details of article 5, www.leginfo.ca.gov (California Business and Professions Code)

ARTICLE 6 - REAL PROPERTY SECURITIES

Article 6 of the Real Estate Law (beginning with Business and Professions Code Section 10237) was in 1998. The Department of Corporations took over responsibility for issuance of security permits.

ARTICLE 7 - MORTGAGE BROKER'S LOAN LAW

Article 7 is known as the **Mortgage Broker's Loan Law** or **Real Property Loan Law**. Under California law any person who negotiates a loan secured by real property for another and for compensation must be licensed as a real estate broker or salesperson. Article 7 regulates the licensee's activities as an arranger of loans.

☞ *Article 7 sets forth disclosure requirements as well as limits on loan costs and fees that can be charged by a mortgage loan broker.*

PURPOSE

The purpose of the **REAL PROPERTY MORTGAGE LOAN LAW** is to protect the borrowers of hard money loans, whether purchase money or not. The law requires that prospective borrowers be supplied with complete loan

information. In other words, the broker must give the applicant a filled-in *Mortgage Loan Disclosure Statement* before the loan is agreed upon. This disclosure statement will give the borrower a reasonably close picture of the final amount of the loan.

MORTGAGE LOAN DISCLOSURE STATEMENT

The broker must provide the borrower with a disclosure statement containing complete loan information, including estimated loan costs, expenses, and commissions to be paid by the borrower.

Form 10-1 is a reproduction of the Mortgage Loan Disclosure Statement produced by the California Department of Real Estate. It contains information about estimated costs, expenses, and commissions to be paid by the applicant for a loan. It also informs the borrower of the approximate net amount that will be received from the loan after paying commissions, costs and expenses, payoffs on liens against the property, and other incidental charges.

- ♦ **Standard Form** - The disclosure must be a form approved by the Commissioner and must include all information required by law.
- ♦ **Execution** - It must be signed by the borrower and the licensee and delivered to the borrower before the borrower becomes obligated.
- ♦ **Retention** - A copy must be retained by the licensee for **four** years.
- ♦ **Delivery** - The disclosure must be delivered to the borrower regardless of loan amount.

PROVISIONS

Applicable to all broker loans - Disclosure requirements and prepayment limitations apply to all loans negotiated by licensees unless the lender is an institution such as a bank or savings and loan association and the broker receives a commission not in excess of 2 percent.

Other provisions regulating costs and commissions apply only to:

- ♦ First trust deeds less than \$30,000.
- ♦ Junior trust deeds less than \$20,000.

The limitations as to loan costs and broker's commission only apply to smaller loans. The parties can agree to commissions and costs without limitation on the larger loans.

REAL ESTATE FINANCE

Form 10-1: Lender/Purchaser Disclosure Statement (RE 851)

STATE OF CALIFORNIA

DEPARTMENT OF REAL ESTATE
MORTGAGE LENDING

LENDER/PURCHASER DISCLOSURE STATEMENT (Loan Origination)

RE 851A (Rev. 1/13)

DISCLOSURE STATEMENT SUMMARY

Note: If this is a multi-lender transaction and more than one property secures the loan, you should also refer to the attached Lender/Purchaser Disclosure Statement Multi-Property (Cross Collateralization) Addendum (RE 851D).

AMOUNT OF THIS LOAN (SEE PART 3)	MARKET VALUE OF PROPERTY (SEE PART 8)	TOTAL AMOUNT OF ENCUMBRANCES SENIOR TO THIS LOAN (SEE PART 9)
\$	\$	\$
TOTAL AMOUNT OF ENCUMBRANCES ANTICIPATED OR EXPECTED TO BE JUNIOR TO THIS LOAN (SEE PART 9)	PROTECTIVE EQUITY (MARKET VALUE MINUS THIS LOAN AND TOTAL SENIOR ENCUMBRANCES)	TOTAL LOAN TO VALUE (SEE PART 10G)
\$	\$	%

PART 1

BROKER INFORMATION

NAME OF BROKER	REAL ESTATE LICENSE ID#
BUSINESS ADDRESS	TELEPHONE NUMBER
NAME OF BROKER'S REPRESENTATIVE	

PART 2

BROKER CAPACITY IN TRANSACTION

THE BROKER IDENTIFIED IN PART 1 OF THIS STATEMENT IS ACTING IN THE FOLLOWING CAPACITY IN THIS TRANSACTION: (CHECK AS APPLIES)

- ☐ A. Agent in arranging a loan on behalf of another
- ☐ B. Principal as a borrower of funds from which broker will directly or indirectly benefit other than through the receipt of commissions, fees and costs and expenses as provided by law for services as an agent.
- ☐ C. Funding a portion of this loan. (Multi-lender transactions are subject to Business and Professions Code Section 10238.)

IF MORE THAN ONE CAPACITY HAS BEEN CHECKED, PROVIDE EXPLANATION HERE.

IF "B" HAS BEEN CHECKED, THE BROKER INTENDS TO USE FUNDS FROM THE LENDER/PURCHASER IN THIS TRANSACTION FOR:

PART 3

TRANSACTION INFORMATION

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD ALSO REFER TO ATTACHED RE 851D.

TERM OF LOAN	PRIORITY OF THIS LOAN (1ST, 2ND, ETC.)	PRINCIPAL AMOUNT	YOUR SHARE IF MULTI-LENDER TRANS.
		\$	\$
INTEREST RATE	(CHECK ONE)		
☐ VARIABLE	☐ AMORTIZED	☐ INTEREST ONLY	
☐ FIXED	☐ PARTIALLY AMORTIZED		
PAYMENT FREQUENCY	APPROXIMATE PAYMENT DUE DATE	AMOUNT OF PAYMENT	YOUR SHARE IF MULTI-LENDER TRANS.
☐ MONTHLY		\$	\$
☐ WEEKLY		\$	\$
BALLOON PAYMENT	APPROX. BALLOON PAYMENT DUE DATE	AMOUNT OF BALLOON PAYMENT	YOUR SHARE IF MULTI-LENDER TRANS.
☐ YES ☐ NO		\$	\$

Balloon Payment — A balloon payment is any installment payment (usually the payment due at maturity) which is greater than twice the amount of the smallest installment payment under the terms of the promissory note or sales contract.

The borrower/vendee may have to obtain a new loan or sell the property to make the balloon payment. If the effort is not successful it may be necessary for the holder of the note/contract to foreclose on the property as a means of collecting the amount owed.

There are subordination provisions. ☐ Yes ☐ No

If YES, explain here or on an attachment.

REAL ESTATE FINANCE

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PART 4

MULTI-LENDER TRANSACTIONS

NAME OF ESCROW HOLDER		ANTICIPATED CLOSING DATE
ADDRESS OF ESCROW HOLDER		
ESTIMATED LENDER COSTS		ESTIMATED BORROWER COSTS — <i>Broker will provide you a copy of the "mortgage loan disclosure statement" given to the borrower or a separate itemization of borrower's costs.</i>
_____	\$ _____	
_____	\$ _____	
_____	\$ _____	
TOTAL	\$ _____	
		TOTAL \$ _____

Servicing

You will be a joint beneficiary with others on this note and you should request a list of names and addresses of the beneficiaries as of the close of escrow from the broker or servicing agent. The beneficiary(ies) holding more than 50% interest in the note may govern the actions to be taken on behalf of all holders in the event of default or other matters. See Civil Code Section 2941.9.

Loan To Value

GENERALLY the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the real property senior thereto, shall not exceed the following percentages of the current market value of the real property as determined in writing by the broker or qualified appraiser.

Single-family residence, owner-occupied	80%
Single-family residence, not owner-occupied	75%
Commercial and income-producing properties	65%
Single-family residentially zoned lot or parcel which has installed off-site improvements including drainage, curbs, gutters, sidewalks, paved roads, and utilities as mandated by the political subdivision having jurisdiction over the lot or parcel	65%
Land which has been zoned for (and if required, approved for subdivision as) commercial or Residential development	50%
Other real property	35%

The percentage amounts specified above may be exceeded when and to the extent that the broker determines that the encumbrance of the property in excess of these percentages is reasonable and prudent considering all relevant factors pertaining to the real property. However, in no event shall the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the property senior thereto, exceed 80 percent of the current fair market value of improved real property or 50 percent of the current fair market value of unimproved real property, except in the case of a single-family residentially zoned lot or parcel as defined above, which shall not exceed 65% of current fair market value of that lot or parcel. A written statement shall be prepared by the broker that sets forth the material considerations and facts that the broker relies upon for his or her determination which shall be disclosed to the lender or note purchaser(s) and retained as a part of the broker's record of the transaction.

NOTE: If more than one property secures this loan, you should also refer to attached RE 851D.

REAL ESTATE FINANCE

RE 851A

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PART 5 SERVICING ARRANGEMENTS

If the loan is to be serviced by a real estate broker you must be notified within ten (10) days if the broker makes any advances on senior encumbrances to protect the security of your note. Depending on the terms and conditions of the servicing contract, you may be obligated to repay any such advances made by the broker. (Note: There must be a servicing agent on multi-lender transactions.) The broker may not guarantee, or imply to guarantee, or advance any payments to you unless a securities permit is obtained from the Department of Corporations.

CHECK APPROPRIATE STATEMENTS

☐ THERE ARE NO SERVICING ARRANGEMENTS (Does not apply to multi-lender transactions.)

☐ BROKER IS THE SERVICING AGENT

☐ ANOTHER QUALIFIED PARTY WILL SERVICE THE LOAN

☐ COPY OF THE SERVICING CONTRACT IS ATTACHED

IF BROKER IS NOT SERVICING AGENT, WHAT IS THE RELATIONSHIP BETWEEN THE BROKER AND SERVICER?

COST TO LENDER FOR SERVICING ARRANGEMENTS (EXPRESS AS DOLLAR AMOUNT OR PERCENTAGE)

PER ☐ MONTH ☐ MONTHLY
☐ YEAR ☐ ANNUALLY
☐ PAYABLE ☐

NAME OF AUTHORIZED SERVICER, IF ANY

BUSINESS ADDRESS

TELEPHONE NUMBER

PART 6 BORROWER INFORMATION

SOURCE OF INFORMATION

☐ BORROWER ☐ BROKER INQUIRY ☐ CREDIT REPORT ☐ OTHER (DESCRIBE)

NAME

CO-BORROWER'S NAME

RESIDENCE ADDRESS

CO-BORROWER'S RESIDENCE ADDRESS

OCCUPATION OR PROFESSION

CO-BORROWER'S OCCUPATION OR PROFESSION

CURRENT EMPLOYER

CO-BORROWER'S CURRENT EMPLOYER

HOW LONG EMPLOYED?

AGE

HOW LONG EMPLOYED?

CO-BORROWER'S AGE

SOURCES OF GROSS INCOME (LIST AND IDENTIFY EACH SOURCE SEPARATELY.)	MONTHLY AMOUNT	CO-BORROWER SOURCES OF GROSS INCOME (LIST AND IDENTIFY EACH SOURCE SEPARATELY.)	MONTHLY AMOUNT
Gross Salary	\$	Gross Salary	\$
OTHER INCOME INCLUDING: Interest	\$	OTHER INCOME INCLUDING: Interest	\$
Dividends	\$	Dividends	\$
Gross Rental Income	\$	Gross Rental Income	\$
Miscellaneous Income	\$	Miscellaneous Income	\$

TOTAL EXPENSES OF ALL BORROWERS (DO NOT COMPLETE IF BORROWER IS A CORPORATION)

Payment of Loan being obtained	\$	Spousal/Child Support	\$
Rent	\$	Insurance	\$
Charge Account/Credit Cards	\$	Vehicle Loan(s)	\$
Mortgage Payments (include taxes and property insurance)	\$	Other (federal & state income taxes, etc.)	\$
TOTAL GROSS MONTHLY INCOME OF BORROWER(S) \$		TOTAL MONTHLY EXPENSES OF BORROWER(S) \$	

REAL ESTATE FINANCE

RE 851A

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The borrower has filed for bankruptcy in the past 12 months. ☐ Yes ☐ No

If YES, the bankruptcy has been discharged or dismissed. ☐ Yes ☐ No

❖ **THE FOLLOWING STATEMENTS ONLY APPLY IF THE BORROWER IS A CORPORATION, PARTNERSHIP OR SOME OTHER FORM OF OPERATING BUSINESS ENTITY.**

Copies of a balance sheet of the entity and income statement covering the indicated period have been supplied by the borrower/obligor and are attached. If no, explain on addendum. ☐ Yes ☐ No

If YES, Date of balance sheet _____

Income statement period (from-to) _____

Financial Statements have been audited by CPA or PA. ☐ Yes ☐ No

Additional information is included on an attached addendum ☐ Yes ☐ No

PART 7 PROPERTY INFORMATION

Identification of property which is security for note. (If no street address, the assessor's parcel number or legal description and a means for locating the property is attached.)

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

STREET ADDRESS _____

OWNER OCCUPIED

☐ NO ☐ YES

ANNUAL PROPERTY TAXES

\$ ☐ ACTUAL ☐ ESTIMATED

ARE TAXES DELINQUENT?

☐ NO ☐ YES

IF YES, AMT. REQUIRED TO BRING CURRENT

\$ _____

SOURCE OF TAX INFORMATION _____

PART 8 APPRAISAL INFORMATION

Estimate of fair market value is to be determined by an independent appraisal, copy of which must be provided to you prior to you obligating funds to make the loan. Note: You may waive the requirement of an independent appraisal, in writing, on a case by case basis, in which case the broker must provide a written estimate of fair market value. The broker must provide you, the investor, with the objective data upon which the broker's estimate is based. **In the case of a construction or rehabilitation loan, an appraisal must be completed by an independent, qualified appraiser in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP).**

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN REFER TO ATTACHED RE 851D.

FAIR MARKET VALUE (ACCORDING TO APPRAISER) (Place this figure or brokers estimate of fair market value on line "F" of Part 10.)

\$ _____

DATE OF APPRAISAL _____

NAME OF APPRAISER (IF KNOWN TO BROKER) _____

PAST AND/OR CURRENT RELATIONSHIP OF APPRAISER TO BROKER (EMPLOYEE, AGENT, INDEPENDENT CONTRACTOR, ETC.) _____

ADDRESS OF APPRAISER _____

DESCRIPTION OF PROPERTY/IMPROVEMENT _____

IS THERE ADDITIONAL SECURING PROPERTY?

☐ YES IF YES, SEE ADDENDUM.
☐ NO

AGE _____

SQUARE FEET _____

TYPE OF CONSTRUCTION _____

IF THE PROPERTY IS CURRENTLY GENERATING INCOME FOR THE BORROWER/OBLIGOR:

ESTIMATED GROSS ANNUAL INCOME

\$ _____

ESTIMATED NET ANNUAL INCOME

\$ _____

REAL ESTATE FINANCE

RE 851A

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PART 9 ENCUMBRANCE INFORMATION

Information is being provided concerning senior encumbrances against the property, to the extent reasonably available from customary sources (excluding the note described on page 1 part 3). **Note:** You have the option to purchase a policy of title insurance or an endorsement to an existing policy of title insurance to insure your interest. You are entitled to a copy of a written loan application and a credit report to obtain information concerning all encumbrances which constitute liens against the property. This information may help determine the financial standing and creditworthiness of the borrower.

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

SOURCE OF INFORMATION

☐ BROKER INQUIRY ☐ BORROWER ☐ OTHER (EXPLAIN)

Are there any encumbrances of record against the securing property at this time? ☐ YES ☐ NO

A. Over the last 12 months were any payments more than 60 days late? ☐ YES ☐ NO

B. If YES, how many? _____

C. Do any of these payments remain unpaid? ☐ YES ☐ NO

D. If YES, will the proceeds of subject loan be used to cure the delinquency? ☐ YES ☐ NO

E. If NO, source of funds to bring the loan current. _____

Encumbrances remaining and/or expected or anticipated to be placed against the property by the borrower/obligor after the close of escrow (excluding the note described on page 1).

ENCUMBRANCE(S) REMAINING (AS REPRESENTED BY THE BORROWER)

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE
	%		%
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT	APPROXIMATE PRINCIPAL BALANCE	ORIGINAL AMOUNT	APPROXIMATE PRINCIPAL BALANCE
\$	\$	\$	\$
MONTHLY PAYMENT	MATURITY DATE	MONTHLY PAYMENT	MATURITY DATE
\$		\$	
BALLOON PAYMENT	IF YES, AMOUNT	BALLOON PAYMENT	IF YES, AMOUNT
☐ YES ☐ NO ☐ UNKNOWN	\$	☐ YES ☐ NO ☐ UNKNOWN	\$

ENCUMBRANCES EXPECTED OR ANTICIPATED (AS REPRESENTED BY THE BORROWER)

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE
	%		%
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT	MATURITY DATE	ORIGINAL AMOUNT	MATURITY DATE
\$		\$	
MONTHLY PAYMENT		MONTHLY PAYMENT	
\$		\$	
BALLOON PAYMENT	IF YES, AMOUNT	BALLOON PAYMENT	IF YES, AMOUNT
☐ YES ☐ NO ☐ UNKNOWN	\$	☐ YES ☐ NO ☐ UNKNOWN	\$

Additional remaining, expected or anticipated encumbrances are set forth in an attachment to this statement. ☐ Yes ☐ No

REAL ESTATE FINANCE

RE 851A

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PART 10

LOAN TO VALUE RATIO

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

- A. Remaining encumbrances senior to this loan (from part 8) \$ _____
- B. Encumbrances expected or anticipated senior to this loan
(from part 9) + \$ _____
- C. Total remaining and expected or anticipated encumbrances senior to this loan = \$ _____
- D. Principal amount of this loan from page 1 part 3 + \$ _____
- E. Total all senior encumbrances and this loan = \$ _____
- F. Fair market value from page 4 part 8 + \$ _____
- G. Loan to value ratio = _____ %

Note: See Part 4 if multi-lender transaction.

NOTICE

The broker has a responsibility to make reasonable efforts to determine that the loan/investment is suitable and appropriate for the lender/purchaser based on information provided by the lender/purchaser regarding the lender/purchaser's financial situation and investment objectives.

ADDITIONAL DISCLOSURES

- Investments in notes secured by trust deeds and real property sales contracts are subject to risk of loss of principal and monthly income. If the borrower stops making payments on any investments you make, you will not receive income; therefore, you cannot rely on this income.
- If your investment is secured by a junior lien and the borrower defaults on a senior lien, it may be necessary for you to meet the obligations of the senior lien in order to protect your security interests, which may include making the senior loan current or paying the senior loan balance in full.
- If your investment is in a multi-lender note and the borrower defaults, foreclosure proceedings will require consensus of a majority of the beneficiaries on the note.
- The trust deed investments that you will make will either name you and your percentage interest in the investment or will be assigned to you. Your trust deed investments are not secured by the real estate collateral unless your interests in those investments are recorded.
- Since trust deed and real property sales contract investments have a maturity date, borrowers are under no obligation to pay off the loan prior to the maturity date. Further, in the case of a balloon payment, there is potential risk that the borrower may not be able to make the balloon payment.

BROKER VERIFICATION

The information in this statement and in the attachments hereto is true and correct to the best of my knowledge and belief.

SIGNATURE OF BROKER OR DESIGNATED REPRESENTATIVE ➤	BROKER/CORPORATION ID#	DATE

ACKNOWLEDGEMENT OF RECEIPT

I, the prospective lender/purchaser, acknowledge receipt of a copy of this statement signed by or on behalf of the broker.

NAME OF PROSPECTIVE LENDER/PURCHASER	
SIGNATURE OF PROSPECTIVE LENDER/PURCHASER ➤	DATE

The California Department of Real Estate does not endorse or offer any opinions regarding the suitability of any proposed or existing real estate investments.

Department of Real Estate license information telephone number: 877-373-4542, or check license status at www.dre.ca.gov. A guide to trust deed investments entitled "Trust Deed Investments - What You Should Know!!" (RE35) is available on the Department's Web site at www.dre.ca.gov under the Publications menu.

INSURANCE LIMITATIONS

"CREDIT LIFE" AND "CREDIT DISABILITY" INSURANCE

This insurance pays off the loan if the insured dies or makes the payments if the insured become disabled.

This type of insurance cannot be required as a condition for making the loan. The licensee may, with the borrower's consent, provide credit life and disability insurance through licensed insurance agents.

- ♦ Coverage may not be in an amount in excess of that reasonably necessary to discharge the obligation of the borrower.
- ♦ The form and rate must be approved by the Insurance Commissioner.
- ♦ The term of the policy may not exceed the length of the loan.

☞ The broker may not require as a condition of the loan, that the borrower purchase credit life insurance or credit disability insurance. business and Professions Code 10241.1)

The lender can insist that **fire and hazard insurance** be obtained on improved property until the loan has been repaid. If licensed to sell such insurance, the loan broker may also act as the insurance agent for the borrower, but borrowers are not obligated to purchase the coverage through the mortgage loan broker. They can use their own insurance agent.

If the borrower elects to purchase such insurance coverage it must be in a form approved by the insurance commissioner and may not be in an amount in excess of what is required to pay off the loan. The licensee can only collect one premium on the loan, even if there are multiple borrowers. Only one borrower may be insured unless another borrower's wages are necessary to make the payments.)

The licensee can collect the cost of fire and hazard insurance if the policy is payable to the borrower and it is sold at a standard rate through a licensed agent.

If insurance premiums are to be paid from the proceeds of this loan, the premium amount cannot be used to determine if the loan is exempt from limitations on cost and fees.

PREPAYMENT PENALTIES

☞ Prepayment penalties are not allowed on loans for owner-occupied dwellings after seven years (a penalty can be charged within seven years). (Business and Professions Code 10242.6)

Twenty percent of the unpaid balance can be prepaid in any 12 month period without being subject to a prepayment penalty. This means that the prepayment penalty would ordinarily only apply to 80 percent of the loan when it is prepaid.

BROKER-CONTROLLED FUNDS

If a broker makes or arranges loans secured by real property and uses any broker- controlled funds, the broker must advise the borrower of this fact not later than the business day following this decision, or at the latest, prior to close of escrow. (Business and Professions Code 10241.2)

Broker-controlled funds are funds owned by the broker, a spouse, child, parent, grandparent, brother, sister in-law or any entity in which the broker alone or with one of the above has a 10 percent or greater interest.

APPRAISAL REPORT COPY

If the borrower pays for an appraisal of real property, a copy of the appraisal report must be given to both the borrower and lender at or before closing the loan transaction. (Business and Professions Code 10241.3)

MAXIMUM ALLOWABLE CHARGES

COST AND CHARGES

The costs and expenses of a loan include appraisal fees, escrow fees, title charges, notary fees, recording fees, and credit investigation fees.

Maximum costs for first trust deed under \$30,000 and second trust deeds under \$20,000 cannot exceed five percent of the loan or **\$390**, whichever is greater, but never more than **\$700**. Costs and expenses can never exceed actual or reasonably earned costs and fees. (Business and Professions Code 10242)

This means that the minimum costs and fees will be \$390 and the maximum will be \$700 with the five percent applicable to numbers in between.

BROKER'S COMMISSION

Mortgage loan brokers are regulated by law in the percentage of commissions they may charge, as shown in table below.

The broker's commission is regulated for first trust deeds under \$30,000 and second trust deeds under \$20,000. Maximum commissions for applicable loans are outlined in table 10-1.

As the table shows, the shorter the term of the loan, the less commission the broker may charge. On loans of \$30,000 and over for first liens, and \$20,000 for junior liens, the broker may charge as much as the borrower agrees to pay. Even for loans covered by the law, however, competition frequently keeps the rates below the maximum allowed.

☞ There is no limit to the commission that can be charged for first trust deeds of \$30, 000 or more, and second trust deeds of \$20, 000 or more.

Figure 10-1: Maximum Commissions

Type of Loan	Less Than Two Years	Two Years but Less Than Three	Three Years and Over	Exempt Transactions
First Trust Deeds	5 %	5%	10%	loans of \$30,000 and over
Junior Trust Deeds	5%	10%	15%	loans of \$20,000 and over

Figure 10-2 Maximum charges for other costs and expenses

Loan Amount	Under \$7,801	\$7,801 to \$13,999	\$14,000 to \$29,999	First loans of \$30,000 and over and junior loans of \$20,000 and over
Maximum Charges	\$390	5% of loan	\$700	No legal limitations

Example:

1. \$5,000 Loan

- $5,000 \times 5\% = \$250$;
Fees can be 5% or \$390--whichever is greater. \$390 is greater than \$250.
2. \$9,000 Loan
 $9,000 \times 5\% = \$450$
Fees can be 5% or \$390--whichever is greater. \$450 is greater than \$390.
3. \$19,000 Loan
 $19,000 \times 5\% = \$950$
Fees can be 5% to a maximum of \$700; fees cannot exceed \$700.

EQUAL PAYMENTS

- ♦ **Loans under three years** - Loans secured by a lien on real property (other than a note given back to the seller by the buyer) which provide for installment payments over a term less than three years shall require equal payments over the loan period, with the final payment not payable until the maturity date. (Business and Professions Code 10244)

☞ No installment, including the final payment, shall be greater than twice the amount of the smallest payment.

In other words, there can be no balloon payments on broker arranged loans for less than three years.

- ♦ **Loans under six years - Owner-occupied** - When the loan is for owner-occupied dwelling, payments must be equal for loans under six years. No balloon payments for loans under six years. (Business and Professions Code 10244.1)

EXEMPT FROM THE MORTGAGE LOAN BROKER LAW

It is easier to state which lenders and what transactions are *not* covered by the law than to list those that are covered.

- ♦ **Regulated institutional lenders.** - Purchase money transactions in which a seller carries back the loan as part of the sale price. However, if a seller is in the business of carrying back loans in eight or more transactions per year, the mortgage loan broker law does apply.
- ♦ Loans secured by first trust deeds when the principal amount is \$30,000 or more.
- ♦ Loans secured by junior trust deeds when the principal amount is \$20,000 or more.

OTHER PROVISIONS

Article 7 also addresses aspects of the licensee's role, liability, balloon and late payments, and insurance.

- ♦ **Exclusive Agreement** - An exclusive authorization to procure a loan requires a definite termination date, and cannot exceed 45 days.
- ♦ **Licensee as lender** - A broker may lend his own money, with written consent of the borrower. A licensed real estate broker is not limited to any maximum rate of interest for arranging or making a real estate loan. A broker is prohibited from imposing other charges if the broker is the lender. Full disclosure to the borrower is required.

BORROWER'S LIABILITY

If the loan is not consummated due to faulty title or borrower's failure to disclose liens, the borrower is liable for costs and expenses incurred, and one-half of the commission.

BALLOON PAYMENTS

Any payment greater than "*twice the amount of the smallest payment*" in the loan schedule is a balloon payment. Usually a balloon payment describes the final payment owing when an amortized loan becomes due if this amount is more than twice the amount of the smallest installment.

Balloon payments are not allowed on:

- ♦ Any loan for less than three years
- ♦ A loan on an owner-occupied dwelling of less than three units for a term of six years or less.

This balloon payment limitation is not applicable to a purchase money note from seller to buyer on any real property transaction.

LATE PAYMENTS

No late charge is permitted if payment is made within **10 days** of due date. When a late charge is permitted, the following limits apply.

- ♦ The penalty is limited to 10 percent of the principal and interest portion of payment. A minimum charge of \$5 can be assessed when the amount due is less than \$50.

PYRAMIDING PROHIBITED

Only one charge can be made for a late payment. If an earlier payment was not paid in full the lender cannot consider all future payments late because of the balance due off the partial or missed payment.

REQUIRED DISCLOSURES STATE REQUIREMENTS

1. Mortgage Loan Disclosure Statement (MLDS).
2. Fair Housing.
3. Lender Purchaser Disclosure Statement (LPDS).
4. Home Mortgage Disclosure Act Reporting.
5. Seller Carryback Requirements.

REQUIRED DISCLOSURES FEDERAL REQUIREMENTS

1. Truth In Lending.
2. Real Estate Settlement Procedures Act.
3. Equal Credit Opportunity Act.
4. Transfer disclosure.
5. Written Authorization to run credit report.

☞ Disclosure is not required if the licensee is negotiating the loan for a "controlled" institution (regulated by law, i.e., banks, savings and loans) and the commission does not exceed two percent of the loan.

GOOD FAITH ESTIMATE - RE FORM 883

RE 883 includes the Good Faith Estimate required by RESPA as well as additional California required disclosures.

APPLICABILITY OF REAL ESTATE LAW

Provisions of the real estate license law do not apply to any employee of a regulated bank, trust company, savings and loan association, industrial loan company, pension trust, credit union, or insurance company.

COMMUNITY REINVESTMENT ACT (CRA)

To guarantee fair lending practices, Congress passed the **COMMUNITY REINVESTMENT ACT (CRA)**, which requires all federally supervised financial institutions to disclose lending data in their lobbies and elsewhere. Lenders are required to report data regarding the race, gender, income, and census tract of people to whom they make loans. Its stated purpose is "to assist in identifying discriminatory practices and enforcing anti-discrimination

statutes." CRA encourages lenders to offer mortgages for low- and moderately priced housing and meet other credit needs for low- and moderate-income families. The basic idea is that if an institution accepts deposits from a certain area, it should also offer loans in that area.

CRA ratings are made public for all banks and thrift institutions. The government grades each institution on how well it:

- ♦ Knows the credit needs of its community.
- ♦ Informs the community about its credit services.
- ♦ Involves its directors in setting up and monitoring CRA programs
- ♦ Participates in government-insured, guaranteed, or subsidized loans.
- ♦ Distributes credit applications, approvals, and rejections across geographic areas.
- ♦ Offers a range of residential mortgages, housing rehabilitation loans, and small business loans.

All of these criteria are designed to protect consumers against unlawful discrimination. A positive CRA rating is a prerequisite for institutions to open new branches and to engage in expansions, acquisitions, and mergers, since outside third parties can petition agencies to deny these activities to institutions with poor CRA grades.

Form 10-2: Good Faith Estimate Disclosure (RE 883)

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STATE OF CALIFORNIA



DEPARTMENT OF REAL ESTATE
Providing Service, Protecting You

MORTGAGE LOAN DISCLOSURE STATEMENT

RE 883 (Rev. 10/10)

- ❖ For any federally related mortgage loan, HUD/RESPA laws require that a Good Faith Estimate (GFE) be provided in addition to this disclosure form.
- ❖ This disclosure statement meets the requirement described in Business and Professions Code (B&P) Section 10240 for loan products offered to the consumer that DO NOT allow the borrower to defer payment of principal and interest (P&I). Each payment will include the full amount of P&I due.
- ❖ For a non-traditional mortgage loan for a 1-4 Unit Residential Property - THIS IS THE WRONG FORM. See RE 885.

This Mortgage Loan Disclosure Statement does not constitute a loan commitment.

BORROWER'S NAME(S)

REAL PROPERTY COLLATERAL: THE INTENDED SECURITY FOR THIS PROPOSED LOAN WILL BE A DEED OF TRUST OR MORTGAGE ON (STREET ADDRESS OR LEGAL DESCRIPTION)

THIS MORTGAGE LOAN DISCLOSURE STATEMENT IS BEING PROVIDED BY THE FOLLOWING CALIFORNIA REAL ESTATE BROKER ACTING AS A MORTGAGE BROKER

INTENDED LENDER TO WHOM YOUR LOAN APPLICATION WILL BE DELIVERED (IF KNOWN)

☐ Unknown

❖ B&P Section 10241 requires the disclosure of all costs and expenses incurred with origination of real estate mortgage loans. The required fee disclosures must include, but are not limited to, the following fees and expenses:

BROKER COMMISSION	ORIGINATION FEE	DISCOUNT POINTS	APPRAISAL FEE	CREDIT REPORTING FEE	TAX SERVICE FEE
PROCESSING FEE	UNDERWRITING FEE	WIRE TRANSFER FEE	FIRE INSURANCE PREMIUM	ESCROW FEE	TITLE INSURANCE FEE
NOTARY FEE	RECORDING FEE	ASSUMPTION FEE	FORWARDING FEE	TRANSFER FEES	TOTAL
BENEFICIARY STATEMENT FEE	FLOOD INSURANCE	OTHER	OTHER	OTHER	

ADDITIONAL REQUIRED CALIFORNIA DISCLOSURES

Proposed Loan Amount \$ _____

Total Fees, Costs, and Expenses from Above \$ _____

Down Payment or Payoffs Liens/Creditors (list) \$ _____

_____ \$ _____

_____ \$ _____

_____ \$ _____

Subtotal \$ _____ \$ _____

Estimated Cash at Closing ☐ To You ☐ That You Must Pay \$ _____

GENERAL INFORMATION ABOUT LOAN

PROPOSED INTEREST RATE: _____ %
Proposed Monthly Loan Payments: \$ _____ Principal & Interest (P&I)
If the loan is a variable interest rate loan, the payment will vary. See loan documents for details.

☐ FIXED RATE ☐ INITIAL VARIABLE RATE
Total Number of Installments: _____
Loan Term: _____ Years _____ Months

PREPAYMENT PENALTY

IS THERE A PREPAYMENT PENALTY? TERMS OF PREPAYMENT

☐ Yes ☐ No

Compensation to Broker

Yield Spread Premium, Service Release Premium or Other Rebate Received from Lender \$ _____

Yield Spread Premium, Service Release Premium or Other Rebate Credited to Borrower \$ _____

Total Amount of Compensation Retained by Broker \$ _____

* Note: The purchase of Credit Life and/or Disability Insurance is NOT required as a condition of making this proposed loan.

REAL ESTATE FINANCE

RE 883 — Page 2 of 2

OTHER LIENS		
LIENS CURRENTLY ON THIS PROPERTY FOR WHICH THE BORROWER IS OBLIGATED		
<i>Lienholder's Name</i>	<i>Amount Owed</i>	<i>Priority</i>
LIST LIENS THAT WILL REMAIN OR ARE ANTICIPATED TO REMAIN ON THIS PROPERTY AFTER THE PROPOSED LOAN FOR WHICH YOU ARE APPLYING IS MADE OR ARRANGED (INCLUDING THE PROPOSED LOAN FOR WHICH YOU ARE APPLYING):		
<i>Lienholder's Name</i>	<i>Amount Owed</i>	<i>Priority</i>
Notice to Borrower: Be sure that you state the amount of all liens as accurately as possible. If you contract with the broker to arrange this loan, but the loan cannot be arranged because you did not state these liens correctly, you may be liable to pay commissions, costs, fees, and expenses even though you do not obtain the loan.		

BALLOON PAYMENT INFORMATION		
IS THIS LOAN SUBJECT TO A BALLOON PAYMENT? ☐ Yes ☐ No	DUE DATE OF FINAL BALLOON PAYMENT (ESTIMATED MONTH/DAY/YEAR)	BALANCE DUE AT MATURITY \$
IF YES, THE FOLLOWING PARAGRAPH APPLIES: NOTICE TO BORROWER: IF YOU DO NOT HAVE THE FUNDS TO PAY THE BALLOON PAYMENT WHEN IT COMES DUE, YOU MAY HAVE TO OBTAIN A NEW LOAN AGAINST YOUR PROPERTY TO MAKE THE BALLOON PAYMENT. IN THAT CASE, YOU MAY AGAIN HAVE TO PAY COMMISSIONS, FEES, AND EXPENSES FOR THE ARRANGING OF THE NEW LOAN. IN ADDITION, IF YOU ARE UNABLE TO MAKE THE MONTHLY PAYMENTS OR THE BALLOON PAYMENT, YOU MAY LOSE THE PROPERTY AND ALL OF YOUR EQUITY THROUGH FORECLOSURE. KEEP THIS IN MIND IN DECIDING UPON THE AMOUNT AND TERMS OF THIS LOAN.		

ARTICLE 7 COMPLIANCE	
If this proposed loan is secured by a first deed of trust in a principal amount of less than \$30,000 or secured by a junior lien in a principal amount of less than \$20,000, the undersigned broker certifies that the loan will be made in compliance with Article 7 of Chapter 3 of the Real Estate Law.	
WILL THIS LOAN BE MADE WHOLLY OR IN PART FROM BROKER CONTROLLED FUNDS AS DEFINED IN SECTION 10241(J) OF THE BUSINESS AND PROFESSIONS CODE? ☐ May ☐ Will ☐ Will Not	
Note: If the broker indicates in the above statement that the loan "may" be made out of broker-controlled funds, the broker must inform the borrower prior to the close of escrow if the funds to be received by the borrower are in fact broker-controlled funds.	

NOTICE TO BORROWER: THIS IS NOT A LOAN COMMITMENT			
Do not sign this statement until you have read and understood all of the information in it. All parts of this form must be completed before you sign it. Borrower hereby acknowledges the receipt of a copy of this statement.			
NAME OF BROKER	LICENSE ID NUMBER	BROKER'S REPRESENTATIVE	LICENSE ID NUMBER
	NMLS ID NUMBER		NMLS ID NUMBER
BROKER'S ADDRESS			
BROKER'S SIGNATURE	DATE	OR SIGNATURE OF REPRESENTATIVE	DATE
BORROWER'S SIGNATURE	DATE	BORROWER'S SIGNATURE	DATE
Department of Real Estate license information telephone number: 877-373-4542, or check license status at www.dre.ca.gov National Mortgage Licensing System: http://mortgage.nationwidelicensingsystem.org/about/pages/nmlsconsumeraccess.aspx The Real Estate Broker negotiating the loan shall retain on file for a period of three years a true and correct copy of this disclosure signed and dated by the borrower(s).			

CHAPTER 10 QUIZ

1. Article 5 of the real estate law does *not* apply to:
 - A. Licensed real estate brokers.
 - B. Brokers who make fewer than 20 loans per year.
 - C. An aggregate amount over five hundred thousand dollars (\$500,000) in a year.
 - D. All of the above.
2. A mortgage loan broker, without authorization to the contrary, cannot retain funds received for a loan payment for more than:
 - A. 24 hours
 - B. 7 days
 - C. 30 days
 - D. 60 days
3. A broker may not advertise a yield different than the rate of the note:
 - A. Under any circumstances.
 - B. Unless a permit was issued by the DRE.
 - C. Unless the rate of the note and discount are stated.
 - D. Unless the broker has put up a \$10,000 bond.
4. In servicing a loan, a broker used personal funds to remit a note to an owner when a purchaser was late on a payment. The broker:
 - A. Has placed her license in jeopardy.
 - B. Must be licensed by the Department of Corporations to advance funds.
 - C. Must give written notice to the lender within 10 days of making the payment.
 - D. Has 7 days to notify the Department of Corporations
5. A broker released funds prior to close of a loan transaction and recording the deed. The broker should deliver the deed to the lender with the recommendation of recording or record it within:
 - A. 24 hours of release of funds.
 - B. 3 days of release of funds.
 - C. 10 days of release of funds.

- D. 60 days of release of funds.
6. Exempt under the Real Property Loan law are:
- A. First trust deeds of under \$30,000.
 - B. Second trust deeds of over \$20,000.
 - C. Purchase money loans carried back by sellers.
 - D. Loans over six years arranged by real estate brokers.
7. Which of the following loans would a broker *not* be limited as to commission or loan costs?
- A. A first trust deed for \$10,000.
 - B. A second trust deed for \$20,000.
 - C. Both A and B.
 - D. Neither A nor B.
8. The maximum that can be charged for a \$10,000 second trust deed including commission and other costs and expense is:
- A. 15 percent of the loan.
 - B. \$500.
 - C. \$390.
 - D. \$700.
9. The law specifically governing the activities of loan brokers is the:
- A. Real Estate law.
 - B. Real Property Loan law.
 - C. Mortgage Loan Disclosure law.
 - D. Real Property Securities Act.
10. An annual report from a loan broker to the Commissioner:
- A Is required of all loan brokers.
 - B Involves a CPA's audit of the loan broker's trust fund accounts.
 - C Is required only of brokers doing a certain minimum volume and dollar amount of business.
 - D Both B and C.

Chapter 10 Answers: 1-B, 2-D, 3-C, 4-C, 5-C, 6-C, 7-B, 8-B, 9-B, 10-D

CHAPTER 11: FINANCING DISCLOSURE REQUIREMENTS



PREVIEW

When a real estate mortgage broker acts as a lender or on behalf of a lender, he must be in compliance with all applicable regulations. In doing so, brokers find that conflicts occur between federal law and state law.

At a federal level, the Consumer Credit Protection Act and the Federal Truth-in-Lending Act are the two most frequently dealt with. In California, both California Department of Corporation (DOC) and Department of Real Estate (DRE) regulations oversee the activities of lenders, including laws found in both the Business Professions Code and California real estate law.

TRUTH IN LENDING ACT / REGULATION Z

Truth-in-Lending is the name used in referring to Regulation Z issued by the Federal Reserve Board under the Consumer Credit Protection Act of 1969. The Federal Trade Commission enforces this law for business firms.

*The purpose of the **TRUTH-IN-LENDING LAW** is to help a borrower understand how much it costs to borrow money. Each lender is required to show its costs in the same way, so borrowers can compare one lender against the other. The tool used to compare one loan against another is called the **annual percentage rate (APR)**.*

The APR is not an interest rate. It is a simple way of informing a borrower of the "effective rate" of interest.

☞ APR is the cost of credit expressed as a yearly rate.

Accuracy of the APR must be within one-eighth of one percent of the actual annual rate for a normal transaction. In irregular transactions, such as where there are multiple advances of funds or irregular payment periods

or amount, accuracy must be within one-fourth of one percent of the rate determined to be the actual annual rate.

To arrive at the total cost, you add not only the total interest paid but various other charges the borrower pays as permitted by statute.

APPLICATION

The purpose of Regulation Z is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. The regulation also gives consumers the right to cancel certain credit transactions that involve a lien on a consumer's principal dwelling. The regulation only requires disclosure. It does not govern or limit charges for consumer credit.

- ♦ **Creditor** - Under this act, a "creditor" is a person or firm who extends consumer credit more than 25 times a year or more than five times a year for transactions secured by dwellings. This does not include persons such as brokers who merely arrange credit from lenders. The effect of this is to exempt real estate brokers from the responsibility of providing "truth in lending" disclosures unless they are themselves acting as "creditors."
- ♦ **Application to Real Estate** - Regulation Z affects "creditors" who offer or extend credit for real estate loans to a natural person for personal, family, or household uses, which are payable in more than four installments or for which a finance charge is made.
- ♦ **Institutions** - The law applies to banks, savings and loan associations, credit unions, consumer finance companies, and residential loan mortgage brokers.
- ♦ **Advertising** - Regulation Z applies to all credit advertising of anyone, not just "creditors."
- ♦ **Exempt Transactions** - In general, transactions which do not involve "consumer" credit are not subject to Regulation Z.
 - Loans to organizations and governments for business, commercial, or agricultural purposes.
 - Non-real estate credit transactions over \$25,000.
 - A loan on borrower's personal residence if the loan is for business use. Includes building a "home office" for business purposes.

DISCLOSURE REQUIREMENTS

A "**creditor**" must furnish the borrower with a Federal Real Estate Loan Disclosure Statement, which includes:

- ♦ **Amount Financed** - The total amount of "credit extended" (frequently less than the face amount of the note.)
- ♦ **Itemization of Amount Financed** - Explanation of additional charges such as appraisal, credit reports, recording, etc. Need not be repeated when estimates of settlement costs have been supplied under RESPA.
- ♦ **Finance Charge** - The total dollar amount that the credit will cost. Included in the finance charge are:
 - Interest
 - Loan fees, assumption fees, finder's fees, and buyer's points
 - Premiums for mortgage guarantee or similar insurance
 - Loan broker's commission
- ♦ **Not included in finance charge** in a transaction secured by real property:
 - Points paid by seller
 - Fees for title examination, abstract of title, title insurance, property survey, and similar services
 - Fees for preparing deeds, mortgages, and reconveyance, settlement, and similar documents
 - Notary, appraisal, and credit report fees
- ♦ **Annual Percentage Rate (APR)** - Relationship between the total finance charge and the total amount financed, expressed as a percentage.
- ♦ **Payment Schedule** - The number, amounts, and timing of payments.
- ♦ **Total of Payments** - The total amount borrower will have paid at the end of the loan period. Total of payments minus amount financed equals finance charge.
- ♦ **Other Items** - Including late payment charges, prepayment penalties, balloon payment, demand feature, lender's assumption policy, and the security interest retained in the property.
 - ♦ **Variable Rate** - For closed-end adjustable rate mortgages (ARMs) there are additional requirements. These are explained in detail in Chapter 8.

RIGHT TO CANCEL

A borrower has the right to rescind before midnight of the **third business day** following consummation of contract, when the security for a loan is real property which is the principal residence of the borrower.

- ♦ **Exempt Transactions** - The right to cancel does not apply to:
 - Any mortgage/trust deed used to finance acquisition or construction of a dwelling, or the assumption of such a mortgage, and
 - Refinancing by the original creditor, "if the original creditor only finances nonfinance charges such as attorney's fees, title examination fees, and insurance premiums."
- ♦ **Failure to Give Notice** - If notice of the right to rescind is not given, the borrower has three years to rescind, or until the property is transferred, whichever is less. The *Notice of Right to Cancel* explains the borrower's rights and complies with this requirement.

Form 11-1: Notice of Right to Cancel

NOTICE OF RIGHT TO CANCEL

Loan Number: _____

Date: _____

Borrowers: _____

Property Address: _____

YOUR RIGHT TO CANCEL:

You are entering into a transaction that will result in a mortgage, lien, or security interest on/in your home. You have a legal right under federal law to cancel this transaction, without cost, within THREE BUSINESS DAYS from whichever of the following events occurs last:

1. the date of the transaction, which is _____; or
2. the date you receive your Truth in Lending disclosures; or
3. the date you receive this notice of your right to cancel.

If you cancel the transaction, the mortgage, lien, or security interest is also cancelled. Within 20 CALENDAR DAYS after we receive your notice, we must take the steps necessary to reflect the fact that the mortgage, lien, or security interest on/in your home has been cancelled, and we must return to you any money or property you have given to us or to anyone else in connection with this transaction.

You may keep any money or property we have given you until we have done the things mentioned above, but you must then offer to return the money or property. If it is impractical or unfair for you to return the property, you must offer its reasonable value. You may offer to return the property at your home or at the location of the property. Money must be returned to the address below. If we do not take possession of the money or property within 20 CALENDAR DAYS of your offer, you may keep it without further obligation.

HOW TO CANCEL:

If you decide to cancel this transaction, you may do so by notifying us in writing,

Name of Creditor: _____

at _____

You may use any written statement that is signed and dated by you and states your intention to cancel, or you may use this notice by dating and signing below. Keep one copy of this notice because it contains important information about your rights.

If you cancel by mail or telegram, you must send a notice no later than midnight of _____ (or midnight of the THIRD BUSINESS DAY following the latest of the three events listed above.) If you send or deliver your written notice to cancel some other way, it must be delivered to the above address no later than that time.

I WISH TO CANCEL

Date

Signature

I/WE ACKNOWLEDGE RECEIPT OF TWO COPIES OF NOTICE OF RIGHT TO CANCEL AND ONE COPY OF THE FEDERAL TRUTH-IN-LENDING DISCLOSURE STATEMENT, ALL GIVEN BY LENDER IN COMPLIANCE WITH TRUTH-IN-LENDING SIMPLIFICATION AND REFORM ACT OF 1980 (PUBLIC LAW 96-221).

Each borrower in this transaction has the right to cancel. The exercise of this right by one borrower shall be effective as to all borrowers.

Borrower's Signature

Date

Borrower's Signature

Date

Borrower's Signature

Date

Borrower's Signature

Date

EFFECT OF RESCISSION

When a customer exercises his right to rescind, he is not liable for any finance or other charges, and any security interest becomes void upon such a rescission. Within 10 days after receipt of a notice of rescission, the creditor shall return to the customer any money or property given as earnest money, down payment, or otherwise, and shall take any action necessary or appropriate to reflect the termination of any security interest created under the transaction. If the creditor has delivered any property to the customer, the customer may retain possession of it. Upon the performance of the creditor's obligations under this section, the customer shall tender the property to the creditor, except that if return of the property in kind would be impractical or inequitable, the customer shall tender its reasonable value. Tender shall be made at the location of the property or at the residence of the customer, at the option of the customer. If the creditor does not take possession of the property within 10 days after tender by the customer, ownership of the property vests in the customer without obligation on his part to pay for it.

NOTICE OF INTENT TO PROCEED

I hereby certify that I have elected not to cancel or rescind the transaction referred to on the reverse side and that I have not delivered, mailed or filed for transmission by telegram to the Creditor any notice of cancellation or rescission of that transaction.

_____ 20 _____
Date and mail or deliver no sooner than three (3) business days after date of receipt.

_____ 20 _____
Customer's Signature

_____ 20 _____
(All joint owners must sign)

ADVERTISING

In order to insure "truth in lending," no real estate advertising of a creditor or real estate licensee containing credit information shall state:

- ♦ The rate of a finance charge ("interest rate") unless stated as Annual Percentage Rate. (The abbreviation "APR" may be used.)
- ♦ Credit terms unless all of the following are stated:
 - Cash price
 - Amount of loan to be extended
 - Required "cash down payment," or statement that none is required
 - Number, amount, and due dates of all payments
 - Annual Percentage Rate
 - Total of all payments over the term of the loan.

PENALTIES

Violators of the Truth in Lending law are subject to:

- ♦ Up to \$5,000 fine and a year in prison
- ♦ Damages payable to borrower for twice the finance charge (not less than \$100, nor more than \$1,000)

HOW TO CALCULATE APR

To understand how the APR is calculated, let's take a simple example.

Example:

Assume you go to a bank and borrow \$1,000 for one year at 15 percent interest. At the end of the year, you pay back the \$1,000 plus \$150 in interest. The APR is the same as the interest rate calculated as follows:

$$APR = \text{Interest} / \text{Money received} = \$150 / \$1,000 = 15\%$$

If the bank collected a \$50 service charge in advance, you would receive \$950, not \$1,000. Therefore, you would have the use of \$950 for one year, not \$1,000.

The APR would be calculated as follows:

$$\text{Interest} + \text{Service charge} / \text{Money received} = \$200 / \$950 = 21\%$$

Under the truth-in-lending law, there are several important terms. A **PREPAID FINANCE CHARGE** is a charge paid separately or withheld from the proceeds of the loan. In real estate transactions, prepaid finance

charges include loan origination fees, prepaid interest, tax service fee, and premiums for mortgage insurance protecting the lender, such as FHA or private mortgage insurance. The *finance charge* is the cost of the loan to the borrower. It is calculated by adding the interest paid over the life of the loan to the prepaid finance charge. The *amount financed* is the amount of the loan less the prepaid finance charges.

If we applied these terms to the previous example, it would look like this:

$$APR = \text{Finance charge} / \text{Amount financed} = (\text{Interest} + \text{Prepaid finance charge}) / (\text{Loan amount} - \text{Prepaid finance charge})$$

Besides stating the APR, the disclosure statement must also provide other loan information, including the prepayment penalty, if any; late charges; and a three-day right of rescission in the case of refinancing and junior loans on a principal dwelling. The right of a borrower to observe this three-day right of rescission may be waived, unless it is lender policy not to allow the waiver. If the lender does allow it, the reason generally acceptable is "financial hardship."

Form 11-2:Mortgage Loan Disclosure Statement (3 pages DRE 851A)

REAL ESTATE FINANCE

STATE OF CALIFORNIA

DEPARTMENT OF REAL ESTATE
MORTGAGE LENDING

LENDER/PURCHASER DISCLOSURE STATEMENT (Loan Origination)

RE 851A (Rev. 1/13)

DISCLOSURE STATEMENT SUMMARY

Note: If this is a multi-lender transaction and more than one property secures the loan, you should also refer to the attached Lender/Purchaser Disclosure Statement Multi-Property (Cross Collateralization) Addendum (RE 851D).

AMOUNT OF THIS LOAN (SEE PART 3)	MARKET VALUE OF PROPERTY (SEE PART 8)	TOTAL AMOUNT OF ENCUMBRANCES SENIOR TO THIS LOAN (SEE PART 9)
\$	\$	\$
TOTAL AMOUNT OF ENCUMBRANCES ANTICIPATED OR EXPECTED TO BE JUNIOR TO THIS LOAN (SEE PART 9)	PROTECTIVE EQUITY (MARKET VALUE MINUS THIS LOAN AND TOTAL SENIOR ENCUMBRANCES)	TOTAL LOAN TO VALUE (SEE PART 10G)
\$	\$	%

PART 1 BROKER INFORMATION

NAME OF BROKER	REAL ESTATE LICENSE ID#
BUSINESS ADDRESS	TELEPHONE NUMBER
NAME OF BROKER'S REPRESENTATIVE	

PART 2 BROKER CAPACITY IN TRANSACTION

THE BROKER IDENTIFIED IN PART 1 OF THIS STATEMENT IS ACTING IN THE FOLLOWING CAPACITY IN THIS TRANSACTION: (CHECK AS APPLIES)

- ☐ A. Agent in arranging a loan on behalf of another
- ☐ B. Principal as a borrower of funds from which broker will directly or indirectly benefit other than through the receipt of commissions, fees and costs and expenses as provided by law for services as an agent.
- ☐ C. Funding a portion of this loan. (Multi-lender transactions are subject to Business and Professions Code Section 10238.)

IF MORE THAN ONE CAPACITY HAS BEEN CHECKED, PROVIDE EXPLANATION HERE.

IF "B" HAS BEEN CHECKED, THE BROKER INTENDS TO USE FUNDS FROM THE LENDER/PURCHASER IN THIS TRANSACTION FOR:

PART 3 TRANSACTION INFORMATION

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD ALSO REFER TO ATTACHED RE 851D.

TERM OF LOAN	PRIORITY OF THIS LOAN (1ST, 2ND, ETC.)	PRINCIPAL AMOUNT	YOUR SHARE IF MULTI-LENDER TRANS.
		\$	\$
INTEREST RATE	(CHECK ONE)		
0% ☐ VARIABLE ☐ FIXED	☐ AMORTIZED ☐ PARTIALLY AMORTIZED ☐ INTEREST ONLY		THE TRUST DEED WILL BE RECORDED.
PAYMENT FREQUENCY	APPROXIMATE PAYMENT DUE DATE	AMOUNT OF PAYMENT	YOUR SHARE IF MULTI-LENDER TRANS.
☐ MONTHLY ☐ WEEKLY		\$	\$
BALLOON PAYMENT	APPROX. BALLOON PAYMENT DUE DATE	AMOUNT OF BALLOON PAYMENT	YOUR SHARE IF MULTI-LENDER TRANS.
☐ YES ☐ NO		\$	\$

Balloon Payment — A balloon payment is any installment payment (usually the payment due at maturity) which is greater than twice the amount of the smallest installment payment under the terms of the promissory note or sales contract.

The borrower/vendee may have to obtain a new loan or sell the property to make the balloon payment. If the effort is not successful it may be necessary for the holder of the note/contract to foreclose on the property as a means of collecting the amount owed.

There are subordination provisions. ☐ Yes ☐ No
If YES, explain here or on an attachment.

REAL ESTATE FINANCE

RE 851A

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PART 4		MULTI-LENDER TRANSACTIONS	
NAME OF ESCROW HOLDER		ANTICIPATED CLOSING DATE	
ADDRESS OF ESCROW HOLDER			
ESTIMATED LENDER COSTS		ESTIMATED BORROWER COSTS — <i>Broker will provide you a copy of the "mortgage loan disclosure statement" given to the borrower or a separate itemization of borrower's costs.</i>	
	\$		
	\$		
	\$		
TOTAL	\$	TOTAL	\$

Servicing

You will be a joint beneficiary with others on this note and you should request a list of names and addresses of the beneficiaries as of the close of escrow from the broker or servicing agent. The beneficiary(ies) holding more than 50% interest in the note may govern the actions to be taken on behalf of all holders in the event of default or other matters. See Civil Code Section 2941.9.

Loan To Value

GENERALLY the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the real property senior thereto, shall not exceed the following percentages of the current market value of the real property as determined in writing by the broker or qualified appraiser.

Single-family residence, owner-occupied	80%
Single-family residence, not owner-occupied	75%
Commercial and income-producing properties	65%
Single-family residentially zoned lot or parcel which has installed off-site improvements including drainage, curbs, gutters, sidewalks, paved roads, and utilities as mandated by the political subdivision having jurisdiction over the lot or parcel	65%
Land which has been zoned for (and if required, approved for subdivision as) commercial or residential development	50%
Other real property	35%

The percentage amounts specified above may be exceeded when and to the extent that the broker determines that the encumbrance of the property in excess of these percentages is reasonable and prudent considering all relevant factors pertaining to the real property. However, in no event shall the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the property senior thereto, exceed 80 percent of the current fair market value of improved real property or 50 percent of the current fair market value of unimproved real property, except in the case of a single-family residentially zoned lot or parcel as defined above, which shall not exceed 65% of current fair market value of that lot or parcel. A written statement shall be prepared by the broker that sets forth the material considerations and facts that the broker relies upon for his or her determination which shall be disclosed to the lender or note purchaser(s) and retained as a part of the broker's record of the transaction.

NOTE: If more than one property secures this loan, you should also refer to attached RE 851D.

REAL ESTATE FINANCE

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PART 5 SERVICING ARRANGEMENTS

If the loan is to be serviced by a real estate broker you must be notified within ten (10) days if the broker makes any advances on senior encumbrances to protect the security of your note. Depending on the terms and conditions of the servicing contract, you may be obligated to repay any such advances made by the broker. (Note: There must be a servicing agent on multi-lender transactions.) The broker may not guarantee, or imply to guarantee, or advance any payments to you unless a securities permit is obtained from the Department of Corporations.

CHECK APPROPRIATE STATEMENTS

☐ THERE ARE NO SERVICING ARRANGEMENTS (Does not apply to multi-lender transactions.)	☐ BROKER IS THE SERVICING AGENT
☐ ANOTHER QUALIFIED PARTY WILL SERVICE THE LOAN	☐ COPY OF THE SERVICING CONTRACT IS ATTACHED
IF BROKER IS NOT SERVICING AGENT, WHAT IS THE RELATIONSHIP BETWEEN THE BROKER AND SERVICER?	COST TO LENDER FOR SERVICING ARRANGEMENTS (EXPRESS AS DOLLAR AMOUNT OR PERCENTAGE)
	☐ MONTH ☐ MONTHLY ☐ YEAR ☐ ANNUALLY ☐ PER ☐ PAYABLE

NAME OF AUTHORIZED SERVICER, IF ANY

BUSINESS ADDRESS

TELEPHONE NUMBER

PART 6 BORROWER INFORMATION

SOURCE OF INFORMATION

☐ BORROWER
 ☐ BROKER INQUIRY
 ☐ CREDIT REPORT
 ☐ OTHER (DESCRIBE)

NAME	CO-BORROWER'S NAME
RESIDENCE ADDRESS	CO-BORROWER'S RESIDENCE ADDRESS
OCCUPATION OR PROFESSION	CO-BORROWER'S OCCUPATION OR PROFESSION
CURRENT EMPLOYER	CO-BORROWER'S CURRENT EMPLOYER
HOW LONG EMPLOYED?	AGE
HOW LONG EMPLOYED?	CO-BORROWER'S AGE

SOURCES OF GROSS INCOME (LIST AND IDENTIFY EACH SOURCE SEPARATELY.)	MONTHLY AMOUNT	CO-BORROWER SOURCES OF GROSS INCOME (LIST AND IDENTIFY EACH SOURCE SEPARATELY.)	MONTHLY AMOUNT
Gross Salary	\$	Gross Salary	\$
OTHER INCOME INCLUDING: Interest	\$	OTHER INCOME INCLUDING: Interest	\$
Dividends	\$	Dividends	\$
Gross Rental Income	\$	Gross Rental Income	\$
Miscellaneous Income	\$	Miscellaneous Income	\$

TOTAL EXPENSES OF ALL BORROWERS (DO NOT COMPLETE IF BORROWER IS A CORPORATION)

Payment of Loan being obtained	\$	Spousal/Child Support	\$
Rent	\$	Insurance	\$
Charge Account/Credit Cards	\$	Vehicle Loan(s)	\$
Mortgage Payments (include taxes and property insurance)	\$	Other (federal & state income taxes, etc.)	\$
TOTAL GROSS MONTHLY INCOME OF BORROWER(S)	\$	TOTAL MONTHLY EXPENSES OF BORROWER(S)	\$

REAL ESTATE FINANCE

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The borrower has filed for bankruptcy in the past 12 months. ☐ Yes ☐ No

If YES, the bankruptcy has been discharged or dismissed. ☐ Yes ☐ No

❖ **THE FOLLOWING STATEMENTS ONLY APPLY IF THE BORROWER IS A CORPORATION, PARTNERSHIP OR SOME OTHER FORM OF OPERATING BUSINESS ENTITY.**

Copies of a balance sheet of the entity and income statement covering the indicated period have been supplied by the borrower/obligor and are attached. If no, explain on addendum. ☐ Yes ☐ No

If YES, Date of balance sheet _____

Income statement period (from-to) _____

Financial Statements have been audited by CPA or PA. ☐ Yes ☐ No

Additional information is included on an attached addendum ☐ Yes ☐ No

PART 7 PROPERTY INFORMATION

Identification of property which is security for note. (If no street address, the assessor's parcel number or legal description and a means for locating the property is attached.)

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

STREET ADDRESS

OWNER OCCUPIED

☐ NO ☐ YES

ANNUAL PROPERTY TAXES

ARE TAXES DELINQUENT?

IF YES, AMT. REQUIRED TO BRING CURRENT

\$ ☐ ACTUAL ☐ ESTIMATED

☐ NO ☐ YES

\$

SOURCE OF TAX INFORMATION

PART 8 APPRAISAL INFORMATION

Estimate of fair market value is to be determined by an independent appraisal, copy of which must be provided to you prior to you obligating funds to make the loan. Note: You may waive the requirement of an independent appraisal, in writing, on a case by case basis, in which case the broker must provide a written estimate of fair market value. The broker must provide you, the investor, with the objective data upon which the broker's estimate is based. **In the case of a construction or rehabilitation loan, an appraisal must be completed by an independent, qualified appraiser in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP).**

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN REFER TO ATTACHED RE 851D.

FAIR MARKET VALUE (ACCORDING TO APPRAISER) (Place this figure or brokers estimate of fair market value on line "F" of Part 10.)

DATE OF APPRAISAL

NAME OF APPRAISER (IF KNOWN TO BROKER)

PAST AND/OR CURRENT RELATIONSHIP OF APPRAISER TO BROKER (EMPLOYEE, AGENT, INDEPENDENT CONTRACTOR, ETC.)

ADDRESS OF APPRAISER

DESCRIPTION OF PROPERTY/IMPROVEMENT

IS THERE ADDITIONAL SECURING PROPERTY?

☐ YES IF YES, SEE ADDENDUM.
☐ NO

AGE

SQUARE FEET

TYPE OF CONSTRUCTION

IF THE PROPERTY IS CURRENTLY GENERATING INCOME FOR THE BORROWER/OBLIGOR:

ESTIMATED GROSS ANNUAL INCOME

ESTIMATED NET ANNUAL INCOME

\$

\$

REAL ESTATE FINANCE

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PART 9 ENCUMBRANCE INFORMATION

Information is being provided concerning senior encumbrances against the property, to the extent reasonably available from customary sources (excluding the note described on page 1 part 3). **Note:** You have the option to purchase a policy of title insurance or an endorsement to an existing policy of title insurance to insure your interest. You are entitled to a copy of a written loan application and a credit report to obtain information concerning all encumbrances which constitute liens against the property. This information may help determine the financial standing and creditworthiness of the borrower.

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

SOURCE OF INFORMATION

☐ BROKER INQUIRY ☐ BORROWER ☐ OTHER (EXPLAIN)

Are there any encumbrances of record against the securing property at this time? ☐ YES ☐ NO

A. Over the last 12 months were any payments more than 60 days late? ☐ YES ☐ NO

B. If YES, how many? _____

C. Do any of these payments remain unpaid? ☐ YES ☐ NO

D. If YES, will the proceeds of subject loan be used to cure the delinquency? ☐ YES ☐ NO

E. If NO, source of funds to bring the loan current. _____

Encumbrances remaining and/or expected or anticipated to be placed against the property by the borrower/obligor after the close of escrow (excluding the note described on page 1).

ENCUMBRANCE(S) REMAINING (AS REPRESENTED BY THE BORROWER)

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE
	%		%
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT	APPROXIMATE PRINCIPAL BALANCE	ORIGINAL AMOUNT	APPROXIMATE PRINCIPAL BALANCE
\$	\$	\$	\$
MONTHLY PAYMENT	MATURITY DATE	MONTHLY PAYMENT	MATURITY DATE
\$		\$	
BALLOON PAYMENT	IF YES, AMOUNT	BALLOON PAYMENT	IF YES, AMOUNT
☐ YES ☐ NO ☐ UNKNOWN	\$	☐ YES ☐ NO ☐ UNKNOWN	\$

ENCUMBRANCES EXPECTED OR ANTICIPATED (AS REPRESENTED BY THE BORROWER)

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE
	%		%
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT	MATURITY DATE	ORIGINAL AMOUNT	MATURITY DATE
\$		\$	
MONTHLY PAYMENT		MONTHLY PAYMENT	
\$		\$	
BALLOON PAYMENT	IF YES, AMOUNT	BALLOON PAYMENT	IF YES, AMOUNT
☐ YES ☐ NO ☐ UNKNOWN	\$	☐ YES ☐ NO ☐ UNKNOWN	\$

Additional remaining, expected or anticipated encumbrances are set forth in an attachment to this statement. ☐ Yes ☐ No

REAL ESTATE FINANCE

RE 851A

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PART 10

LOAN TO VALUE RATIO

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

- A. Remaining encumbrances senior to this loan (from part 8) \$ _____
- B. Encumbrances expected or anticipated senior to this loan
(from part 9) + \$ _____
- C. Total remaining and expected or anticipated encumbrances senior to this loan..... = \$ _____
- D. Principal amount of this loan from page 1 part 3 + \$ _____
- E. Total all senior encumbrances and this loan = \$ _____
- F. Fair market value from page 4 part 8 ÷ \$ _____
- G. Loan to value ratio = _____ %

Note: See Part 4 if multi-lender transaction.

NOTICE

The broker has a responsibility to make reasonable efforts to determine that the loan/investment is suitable and appropriate for the lender/purchaser based on information provided by the lender/purchaser regarding the lender/purchaser's financial situation and investment objectives.

ADDITIONAL DISCLOSURES

- Investments in notes secured by trust deeds and real property sales contracts are subject to risk of loss of principal and monthly income. If the borrower stops making payments on any investments you make, you will not receive income; therefore, you cannot rely on this income.
- If your investment is secured by a junior lien and the borrower defaults on a senior lien, it may be necessary for you to meet the obligations of the senior lien in order to protect your security interests, which may include making the senior loan current or paying the senior loan balance in full.
- If your investment is in a multi-lender note and the borrower defaults, foreclosure proceedings will require consensus of a majority of the beneficiaries on the note.
- The trust deed investments that you will make will either name you and your percentage interest in the investment or will be assigned to you. Your trust deed investments are not secured by the real estate collateral unless your interests in those investments are recorded.
- Since trust deed and real property sales contract investments have a maturity date, borrowers are under no obligation to pay off the loan prior to the maturity date. Further, in the case of a balloon payment, there is potential risk that the borrower may not be able to make the balloon payment.

BROKER VERIFICATION

The information in this statement and in the attachments hereto is true and correct to the best of my knowledge and belief.

SIGNATURE OF BROKER OR DESIGNATED REPRESENTATIVE

BROKER/CORPORATION ID#

DATE

➤

ACKNOWLEDGEMENT OF RECEIPT

I, the prospective lender/purchaser, acknowledge receipt of a copy of this statement signed by or on behalf of the broker.

NAME OF PROSPECTIVE LENDER/PURCHASER

SIGNATURE OF PROSPECTIVE LENDER/PURCHASER

DATE

➤

The California Department of Real Estate does not endorse or offer any opinions regarding the suitability of any proposed or existing real estate investments.

Department of Real Estate license information telephone number: 877-373-4542, or check license status at www.dre.ca.gov. A guide to trust deed investments entitled "Trust Deed Investments - What You Should Know!!" (RE35) is available on the Department's Web site at www.dre.ca.gov under the Publications menu.

PURCHASE MONEY CREDIT EXTENDED BY SELLERS

For purchase money credit applies to seller carryback credit situations involving one- to four-family dwellings.

Arranger of Credit - In California law, an "arranger of credit" is:

- ♦ A person, other than a party to the transaction, who is involved in developing or negotiating credit terms, or any transaction or transfer of real property which is facilitated by that extension of credit, excluding attorneys, or
- ♦ A party to the transaction who is a real estate licensee or an attorney.

APPLICATION

Applies to seller carryback situations involving one- to four-family dwellings.

Exempt Transactions - Disclosures under this law are not required:

- ♦ When the purchaser is entitled to receive a federal Truth in Lending disclosure statement, a RESPA disclosure statement, or a Mortgage Loan Broker's Statement, under Article 7.
- ♦ When the vendor is entitled to receive a disclosure statement under Article 5, California Real Estate Law, or certain disclosures required by Corporations Code Section 25110.

DISCLOSURE REQUIREMENTS

When credit is extended by the seller and there is an "arranger of credit," disclosure responsibilities are as follows:

- ♦ A written disclosure shall be given to the purchaser by the arranger of credit and vendor, and,
- ♦ To the vendor by the arranger of credit and buyer.
- ♦ If two or more arrangers of credit are involved, the one who has obtained the offer to purchase makes the disclosure.

DISCLOSURE DOCUMENT

The CAR Seller Financing Disclosure Statement form (Form 11-2), is a standard form for this disclosure statement.

Contents - The required disclosures include both specific terms of the transaction at hand, and general disclosures about the financing process:

- ♦ Identification of the note (or other documents) and of the property used as security
- ♦ Description of terms or a copy of them
- ♦ Description and conditions of each recorded senior lien
- ♦ The source and purpose of any cash purchaser is to receive
- ♦ A warning of difficulties which may arise in refinancing, if full amortization does not occur
- ♦ A disclosure whether negative amortization can occur
- ♦ Possible acceleration clauses
- ♦ Possible balloon payments
- ♦ Information about credit of borrower, his income, and a warning about Section 580b as to "deficiency judgments"
- ♦ Loss-payee clauses in insurance
- ♦ Title insurance coverages
- ♦ Tax service
- ♦ The importance of recording

Timing Disclosure must be given before execution of notes or security documents. Buyer and vendor must give a written receipt for the disclosure and the arranger must keep a copy for three years.

Form 11-3: Seller Financing and Disclosure (CAR SFA)

REAL ESTATE FINANCE



CALIFORNIA
ASSOCIATION
OF REALTORS®

SELLER FINANCING ADDENDUM AND DISCLOSURE

(California Civil Code §§2956-2967)

(C.A.R. Form SFA, Revised 10/02)

This is an addendum to the ☐ Residential Purchase Agreement, ☐ Counter Offer, or ☐ Other _____, ("Agreement"), dated _____, ("Property"),
On property known as 123 Main St, Main City, CA 99999, between _____ ("Buyer"),
and _____ ("Seller").

Seller agrees to extend credit to Buyer as follows:

1. **PRINCIPAL; INTEREST; PAYMENT; MATURITY TERMS:** ☐ Principal amount \$ _____, interest at _____ % per annum, payable at approximately \$ _____ per ☐ month, ☐ year, or ☐ other _____, remaining principal balance due in _____ years.
2. **LOAN APPLICATION; CREDIT REPORT:** Within 5 (or ☐) Days After Acceptance: (a) Buyer shall provide Seller a completed loan application on a form acceptable to Seller (such as a FNMA/FHLMC Uniform Residential Loan Application for residential one to four unit properties); and (b) Buyer authorizes Seller and/or Agent to obtain, at Buyer's expense, a copy of Buyer's credit report. Buyer shall provide any supporting documentation reasonably requested by Seller. Seller, after first giving Buyer a Notice to Buyer to Perform, may cancel this Agreement in writing and authorize return of Buyer's deposit if Buyer fails to provide such documents within that time, or if Seller disapproves any above item within 5 (or ☐) Days After receipt of each item.
3. **CREDIT DOCUMENTS:** This extension of credit by Seller will be evidenced by: ☐ Note and deed of trust; ☐ All-inclusive note and deed of trust; ☐ Installment land sale contract; ☐ Lease/option (when parties intend transfer of equitable title); OR ☐ Other (specify) _____

THE FOLLOWING TERMS APPLY ONLY IF CHECKED. SELLER IS ADVISED TO READ ALL TERMS, EVEN THOSE NOT CHECKED, TO UNDERSTAND WHAT IS OR IS NOT INCLUDED, AND, IF NOT INCLUDED, THE CONSEQUENCES THEREOF.

4. ☐ **LATE CHARGE:** If any payment is not made within _____ Days After it is due, a late charge of either \$ _____, or _____ % of the installment due, may be charged to Buyer. **NOTE:** on single family residences that Buyer intends to occupy, California Civil Code §2954.4(a) limits the late charge to no more than 6% of the total monthly payment due and requires a grace period of no less than 10 days.
5. ☐ **BALLOON PAYMENT:** The extension of credit will provide for a balloon payment, in the amount of \$ _____, plus any accrued interest, which is due on _____ (date).
6. ☐ **PREPAYMENT:** If all or part of this extension of credit is paid early, Seller may charge a prepayment penalty as follows (if applicable): _____ . Caution: California Civil Code §2954.9 contains limitations on prepayment penalties for residential one-to-four unit properties.
7. ☐ **DUE ON SALE:** If any interest in the Property is sold or otherwise transferred, Seller has the option to require immediate payment of the entire unpaid principal balance, plus any accrued interest.
- 8.* ☐ **REQUEST FOR COPY OF NOTICE OF DEFAULT:** A request for a copy of Notice of Default as defined in California Civil Code §2924e will be recorded. **If not**, Seller is advised to consider recording a Request for Notice of Default.
- 9.* ☐ **REQUEST FOR NOTICE OF DELINQUENCY:** A request for Notice of Delinquency, as defined in California Civil Code §2924e, to be signed and paid for by Buyer, will be made to senior lienholders. **If not**, Seller is advised to consider making a Request for Notice of Delinquency. Seller is verified to check with senior lienholders to verify whether they will honor this request.
- 10.* ☐ **TAX SERVICE:**
 - A. If property taxes on the Property become delinquent, tax service will be arranged to report to Seller. **If not**, Seller is advised to consider retaining a tax service, or to otherwise determine that property taxes are paid.
 - B. ☐ Buyer, ☐ Seller, shall be responsible for the initial and continued retention of, and payment for, such tax service.
11. ☐ **TITLE INSURANCE:** Title insurance coverage will be provided to **both** Seller and Buyer, insuring their respective interests in the Property. **If not**, Buyer and Seller are advised to consider securing such title insurance coverage.
12. ☐ **HAZARD INSURANCE:**
 - A. The parties' escrow holder or insurance carrier will be directed to include a loss payee endorsement, adding Seller to the Property insurance policy. **If not**, Seller is advised to secure such an endorsement, or acquire a separate insurance policy.
 - B. Property insurance **does not** include earthquake or flood insurance coverage, unless checked:
☐ Earthquake insurance will be obtained; ☐ Flood insurance will be obtained.
13. ☐ **PROCEEDS TO BUYER:** Buyer will receive cash proceeds at the close of the sale transaction. The amount received will be approximately \$ _____, from _____ (indicate source of proceeds). Buyer represents that the purpose of such disbursement is as follows: _____
14. ☐ **NEGATIVE AMORTIZATION; DEFERRED INTEREST:** Negative amortization results when Buyer's periodic payments are less than the amount of interest earned on the obligation. Deferred interest also results when the obligation does not require periodic payments for a period of time. In either case, interest is not payable as it accrues. This accrued interest will have to be paid by Buyer at a later time, and may result in Buyer owing more on the obligation than at its origination. The credit being extended to Buyer by Seller will provide for negative amortization or deferred interest as indicated below. (Check A, B, or C. CHECK ONE ONLY.)
 - ☐ A. All negative amortization or deferred interest shall be added to the principal _____ (e.g., annually, monthly, etc.), and thereafter shall bear interest at the rate specified in the credit documents (compound interest);
 - OR ☐ B. All deferred interest shall be due and payable, along with principal, at maturity;
 - OR ☐ C. Other _____

*(For Paragraphs 8-10) In order to receive timely and continued notification, Seller is advised to record appropriate notices and/or to notify appropriate parties of any change in Seller's address.

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SFA REVISED 10/02 (PAGE 1 OF 3)

Buyer's Initials (_____) (_____)
Seller's Initials (_____) (_____)

Reviewed by _____ Date _____



SELLER FINANCING ADDENDUM AND DISCLOSURE (SFA PAGE 1 OF 3)

Agent: Jessica Huang	Phone: (626)855-0455	Fax:	Prepared using zipForm® software
Broker: Dynasty Realty 2373 S. Hacienda Blvd Hacienda Heights, CA 91745			

REAL ESTATE FINANCE

Property Address: 123 Main St, Main City, CA 99999

Date: _____

15. ☐ **ALL-INCLUSIVE DEED OF TRUST; INSTALLMENT LAND SALE CONTRACT:** This transaction involves the use of an all-inclusive (or wraparound) deed of trust or an installment land sale contract. That deed of trust or contract shall provide as follows:
- A. In the event of an acceleration of any senior encumbrance, the party responsible for payment, or for legal defense is: ☐ Buyer ☐ Seller ;
OR ☐ Is not specified in the credit or security documents.
- B. In the event of the prepayment of a senior encumbrance, the responsibilities and rights of Buyer and Seller regarding refinancing, prepayment penalties, and any prepayment discounts are: _____ ;
OR ☐ Are not specified in the documents evidencing credit.
- C. Buyer will make periodic payments to _____ (Seller, collection agent, or any neutral third party), who will be responsible for disbursing payments to the payee(s) on the senior encumbrance(s) and to Seller.
NOTE: The Parties are advised to designate a neutral third party for these purposes.
16. ☐ **TAX IDENTIFICATION NUMBERS:** Buyer and Seller shall each provide to each other their Social Security Numbers or Taxpayer Identification Numbers.
17. ☐ **OTHER CREDIT TERMS:** _____
18. ☐ **RECORDING:** The documents evidencing credit (paragraph 3) will be recorded with the county recorder where the Property is located. **If not,** Buyer and Seller are advised that their respective interests in the Property may be jeopardized by intervening liens, judgments, encumbrances, or subsequent transfers.
19. ☐ **JUNIOR FINANCING:** There will be additional financing, secured by the Property, junior to this Seller financing. Explain: _____
20. **SENIOR LOANS AND ENCUMBRANCES:** The following information is provided on loans and/or encumbrances that will be **senior** to Seller financing. **NOTE:** The following are estimates, unless otherwise marked with an asterisk (*). If checked: ☐ A separate sheet with information on additional senior loans/encumbrances is attached.
- | | 1st | 2nd |
|---|----------|------------------|
| A. Original Balance | \$ _____ | \$ _____ |
| B. Current Balance | \$ _____ | \$ _____ |
| C. Periodic Payment (e.g. \$100/month): | \$ _____ | \$ _____ / _____ |
| Including Impounds of: | \$ _____ | \$ _____ / _____ |
| D. Interest Rate (per annum) | % _____ | % _____ |
| E. Fixed or Variable Rate: | _____ | _____ |
| If Variable Rate: Lifetime Cap (Ceiling): | _____ | _____ |
| Indicator (Underlying Index) | _____ | _____ |
| Margins | _____ | _____ |
| F. Maturity Date | _____ | _____ |
| G. Amount of Balloon Payment | \$ _____ | \$ _____ |
| H. Date Balloon Payment Due | _____ | _____ |
| I. Potential for Negative Amortization? (Yes, No, or Unknown) | _____ | _____ |
| J. Due on Sale? (Yes, No, or Unknown) | _____ | _____ |
| K. Pre-payment penalty? (Yes, No, or Unknown) | _____ | _____ |
| L. Are payments current? (Yes, No, or Unknown) | _____ | _____ |
21. **BUYER'S CREDITWORTHINESS:** (CHECK EITHER A OR B. Do not check both.) In addition to the loan application, credit report and other information requested under paragraph 2:
- A. ☐ No other disclosure concerning Buyer's creditworthiness has been made to Seller;
- OR B. ☐ The following representations concerning Buyer's creditworthiness are made by Buyer(s) to Seller:
- | | |
|-------------------------------|-------------------------------|
| Borrower | Co-Borrower |
| 1. Occupation _____ | 1. Occupation _____ |
| 2. Employer _____ | 2. Employer _____ |
| 3. Length of Employment _____ | 3. Length of Employment _____ |
| 4. Monthly Gross Income _____ | 4. Monthly Gross Income _____ |
| 5. Other _____ | 5. Other _____ |
22. **ADDED, DELETED OR SUBSTITUTED BUYERS:** The addition, deletion or substitution of any person or entity under this Agreement or to title prior to close of escrow shall require Seller's written consent. Seller may grant or withhold consent in Seller's sole discretion. Any additional or substituted person or entity shall, if requested by Seller, submit to Seller the same documentation as required for the original named Buyer. Seller and/or Brokers may obtain a credit report, at Buyer's expense, on any such person or entity.

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SFA REVISED 10/02 (PAGE 2 OF 3)

Buyer's Initials (_____) (_____)
Seller's Initials (_____) (_____)

Reviewed by _____ Date _____



SELLER FINANCING ADDENDUM AND DISCLOSURE (SFA PAGE 2 OF 3)

Untitled

REAL ESTATE FINANCE

Property Address: 123 Main St., Main City, CA 99999

Date: _____

23. CAUTION:

- A.** If the Seller financing requires a balloon payment, Seller shall give Buyer written notice, according to the terms of Civil Code §2966, at least 90 and not more than 150 days before the balloon payment is due if the transaction is for the purchase of a dwelling for not more than four families.
- B.** If **any** obligation secured by the Property calls for a balloon payment, Seller and Buyer are aware that refinancing of the balloon payment at maturity may be difficult or impossible, depending on conditions in the conventional mortgage marketplace at that time. There are no assurances that new financing or a loan extension will be available when the balloon prepayment, or any prepayment, is due.
- C.** If **any** of the existing or proposed loans or extensions of credit would require refinancing as a result of a lack of full amortization, such refinancing might be difficult or impossible in the conventional mortgage marketplace.
- D.** In the event of default by Buyer: (1) Seller may have to reinstate and/or make monthly payments on any and all senior encumbrances (including real property taxes) in order to protect Seller's secured interest; (2) Seller's rights are generally limited to foreclosure on the Property, pursuant to California Code of Civil Procedure §580b; and (3) the Property may lack sufficient equity to protect Seller's interests if the Property decreases in value.

If this three-page Addendum and Disclosure is used in a transaction for the purchase of a dwelling for not more than four families, it shall be prepared by an Arranger of Credit as defined in California Civil Code §2957(a). (The Arranger of Credit is usually the agent who obtained the offer.)

Arranger of Credit - (Print Firm Name) _____

By _____

Date _____

Address _____ City _____ State _____ Zip _____

Phone _____ Fax _____

BUYER AND SELLER ACKNOWLEDGE AND AGREE THAT BROKERS: (A) WILL NOT PROVIDE LEGAL OR TAX ADVICE; (B) WILL NOT PROVIDE OTHER ADVICE OR INFORMATION THAT EXCEEDS THE KNOWLEDGE, EDUCATION AND EXPERIENCE REQUIRED TO OBTAIN A REAL ESTATE LICENSE; OR (C) HAVE NOT AND WILL NOT VERIFY ANY INFORMATION PROVIDED BY EITHER BUYER OR SELLER. BUYER AND SELLER AGREE THAT THEY WILL SEEK LEGAL, TAX, AND OTHER DESIRED ASSISTANCE FROM APPROPRIATE PROFESSIONALS. BUYER AND SELLER ACKNOWLEDGE THAT THE INFORMATION EACH HAS PROVIDED TO THE ARRANGER OF CREDIT FOR INCLUSION IN THIS DISCLOSURE FORM IS ACCURATE. BUYER AND SELLER FURTHER ACKNOWLEDGE THAT EACH HAS RECEIVED A COMPLETED COPY OF THIS DISCLOSURE FORM.

Buyer _____ Date _____
(signature)

Address _____ City _____ State _____ Zip _____

Phone _____ Fax _____ E-mail _____

Buyer _____ Date _____
(signature)

Address _____ City _____ State _____ Zip _____

Phone _____ Fax _____ E-mail _____

Seller _____ Date _____
(signature)

Address _____ City _____ State _____ Zip _____

Phone _____ Fax _____ E-mail _____

Seller _____ Date _____
(signature)

Address _____ City _____ State _____ Zip _____

Phone _____ Fax _____ E-mail _____

THIS FORM HAS BEEN APPROVED BY THE CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.). NO REPRESENTATION IS MADE AS TO THE LEGAL VALIDITY OR ADEQUACY OF ANY PROVISION IN ANY SPECIFIC TRANSACTION. A REAL ESTATE BROKER IS THE PERSON QUALIFIED TO ADVISE ON REAL ESTATE TRANSACTIONS. IF YOU DESIRE LEGAL OR TAX ADVICE, CONSULT AN APPROPRIATE PROFESSIONAL.

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Reviewed by _____ Date _____



SFA REVISED 10/02 (PAGE 3 OF 3)

SELLER FINANCING ADDENDUM AND DISCLOSURE (SFA PAGE 3 OF 3)

Untitled

BALLOON PAYMENTS

If a balloon payment is involved, the holder of the note must mail to the trustor or successor in interest, not less than 90 days, nor more than 150 days before the balloon is due:

- ♦ The name and address of the person to whom payment is due,
- ♦ The date and amount due, and
- ♦ Statement of trustor's right to refinance, if any.

Failure to give notice postpones due date until 90 days after mailing or delivery of notice.

Civil Code §29241 - A similar requirement of notice at least 90 days in advance applies to all loans with balloon payments:

- ♦ On owner-occupied one- to four-family properties
- ♦ Made after January 1, 1984
- ♦ For a term in excess of one year

Disclosure The note must include a disclosure of the right to receive notice of an impending balloon payment.

REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)

RESPA was passed in 1974 to standardize the settlement or closing of real estate transactions. According to the act, the purpose was to affect certain changes in the settlement procedures for residential real estate transactions that will result:

- ♦ In more effective advance disclosure to the homebuyer and seller of settlement costs.
- ♦ In the elimination of kickbacks or referral fees that tend to unnecessarily increase the costs of certain settlement services.
- ♦ In a reduction in the amounts homebuyers are required to place in escrow accounts.
- ♦ In significant reform and modernization of local record keeping of land title information.

In this discussion only some portions of RESPA dealing with the closing of residential transactions will be discussed.

APPLICATION

RESPA applies to a federally-related loan secured by a first security interest, on a one- to four-unit residential property.

- ♦ **Federally-Related** - This term is broad enough to include loans made by any lender insured by FDIC or FSLIC, or approved to make FHA-insured or DVA-guaranteed loans.

☞ *By this definition, the majority of conventional principal residence loans are covered by RESPA.*

DISCLOSURE REQUIREMENTS

For any loan transaction covered by the Act, the lender must comply with the following requirements.

- ♦ **HUD Brochure** - The lender must send a brochure to each loan applicant on receipt of the application. The entire text of the brochure is prescribed by the Secretary of Housing and Urban Development in 12 US Code §2604.
- ♦ **Estimate of Closing Costs** - The lender must also provide a good faith estimate of all closing costs, including all fees charged by the lender:
 - Loan origination fee
 - Appraisal fee
 - Credit report expenses
- ♦ Closing costs charged by others, such as:
 - Escrow fees
 - Title insurance costs
 - Recording fees

UNIFORM SETTLEMENT STATEMENT

The "person conducting the settlement" (usually the escrow holder) must provide to both seller and buyer a completed Uniform Settlement Statement (HUD-1 Statement).

- ♦ **Timing** - The Uniform Settlement Statement must be delivered or mailed to the borrower and the seller at or before settlement. Upon request of the borrower, the person conducting the settlement must permit the borrower to inspect the Uniform Settlement Statement one day prior to settlement.
- ♦ **Exceptions** - The statement may be provided by mail as soon as possible after the settlement if:
 - The escrow holder does not require a meeting of the parties,
 - The borrower or borrower's agent does not attend the settlement in person, or

- The borrower waives in writing the right to delivery of the completed statement.

The Real Estate Settlement Procedures Act (RESPA) is a federal law designed to give buyers and sellers advance notice of closing costs, allowing them to "comparison shop" and obtain the lowest available costs.

RESPA HAS NINE BASIC REQUIREMENTS:

1. The first two provisions require the lender to provide the applicant with **good faith estimate** of costs and the HUD booklet on settlement costs.
2. The remainder of the provisions covers the actual closing of the transaction:
3. **Uniform Settlement Statement** - RESPA requires the use of the Uniform Settlement Statement, otherwise known as either HUD Form 1 or the closing statement. This will be reviewed later in this section.
4. **Selection Of The Title Company** - RESPA makes it illegal for the seller to condition the sale of the property that will be purchased with the assistance of a federally related mortgage bank, upon the buyer's selection of the title company. This means that the seller cannot force the buyer to use a specific title company.
5. **Kickbacks** - RESPA prohibits anyone involved in the transaction from receiving or giving a fee, kickback, or anything of value for the promise of future business. It also makes the acceptance or offer of a fee illegal when no service has been rendered. This requirement does not prohibit a person who actually provides a service in the transaction from collecting a fee or payment for services. It does prohibit title or mortgage companies from making agreements with a real estate agent or firm that for every closing or applicant the agent or firm sends, the agent or firm will receive something of value.
6. **Escrows** - RESPA prohibits the lender from collecting excessive amounts to be placed in escrow accounts. The act allows the lender to collect sufficient amounts to make necessary payments plus two months of escrow deposits. Thus, at the time of closing, the mortgage lender usually requires the collection of two months of escrow payments for taxes, insurance (homeowners), PMI premiums, and any other fee or assessment that will affect the title to the property. The lender will collect the first year's premium for

both homeowners' insurance and PM if required, for a total of 14 months for each.

7. **Preparation of the Uniform Settlement Statement and Truth-in-Lending statement** - The lender is prohibited from charging a fee for the preparation of these two statements. It should be noted that only the lender is prohibited from charging a fee for the preparation of the statements.
8. **Loans To Fiduciaries** - Institutions insured by FDIC require that the borrower disclose the identity of the person or company receiving the beneficial interest in a loan made to a fiduciary. Fiduciary is the holding by a person or organization of something in trust. If you are purchasing a piece of property from a person or organization that is holding the property in trust, the institution requires the person or organization holding the property to identify the person or persons who will ultimately benefit from the proceeds of the mortgage.
9. **Preview Of Settlement Statement** - The final provision of RESPA allows the borrower or his agent to view the Uniform Settlement Statement one business day prior to the closing and note the amount the borrower may be required to pay at the time of closing. This reviewing of the Uniform Settlement Statement is a good idea not only for the borrower, but also for the real estate agent who represents the borrower. It allows the borrower to have sufficient cash or a cashier's check to pay the required amount. If the agent reviews the Uniform Settlement Statement prior to closing, he can see if the buyer is paying the proper items and amounts outlined in the earnest money contract.

PROHIBITIONS

To hold down closing costs, Congress included some prohibitions and limitations in the law.

- ♦ No giving or accepting kickbacks or unearned fees (referral fees) to unlicensed persons for settlement related activities.
- ♦ Limitations are placed on the initial amounts which a lender may collect for establishing new insurance and tax reserves

EXCLUSIONS

RESPA does not apply to construction and home improvement loans, vacant lots, parcels of 25 acres or more, assumptions, property purchased for resale, land sales contracts, or any transaction in which title is not transferred.

HOUSING FINANCIAL DISCRIMINATION ACT

The **HOUSING FINANCIAL DISCRIMINATION ACT OF 1977** (Holden Act), was enacted in California in 1977 to deter a discriminatory practice known as "**redlining**," the blanket refusal by some lenders to make loans in neighborhoods of fading property values.

The Holden Act applies to **owner-occupied residential properties** of one to four units. The act also includes non-owner-occupied loans on up to four units if 50 percent or more of the loan proceeds are to be used to improve the property.

- ♦ Application
 - **Borrower** - The Holden Act prohibits consideration of an applicant's race, color, religion, sex, marital status, national origin, or ancestry in providing financial assistance.
 - **Neighborhood** - Financial assistance cannot be denied because of the ethnic composition or expected trends in the neighborhood.
- ♦ **Allowable Considerations** - While the Act prohibits discrimination in lending and appraisal practices, it does not preclude a lender considering the fair market value of property which will be used to secure the loan, nor lend if it is evident that occupancy of the property will endanger the health and safety of the resident.

DISCLOSURE

To insure that prospective borrowers are aware of their rights under this law, lenders must notify all loan applicants at the time of the completed loan application of the existence of the Holden Act.

- ♦ **Form and Content** - The notice must include the address where complaints may be filed and information obtained. The notice must be in at least 10 point type and posted in a conspicuous location in the lender's place of business.
- ♦ **Complaints** - Any applicant seeking a real estate loan for a personal residence (not more than four dwelling units) who suspects discrimination under this law may file a complaint with the Secretary of the Business, Transportation, and Housing Agency.
- ♦ **Compliance** - If the secretary or designee finds that a lender has engaged in unlawful practices, the lender may be required to make the loan, or if that is no longer a viable solution, the lender may be made to pay damages to the complainant.

PURPOSE

The act states that financial institutions cannot deny or discriminate in fixing the amount, interest rate, or length of the loan based upon:

- ♦ Race, color, religion, sex, marital status, sexual orientation, national origin, handicap, ancestry, or other characteristics of the borrower.
- ♦ Racial, ethnic, religious, national origin, or income level composition of a neighborhood or whether that composition is expected to change.
- ♦ The act also prohibits ***discrimination by effect***. That means that the institution cannot engage in a lending practice that has a discriminatory effect against a protected group, unless that practice is required to achieve a legitimate business purpose. If it is clear that a practice has a discriminatory effect, then the burden is on the institution to show that the practice is required. This is called the "Effects Test."

Some examples of discrimination by effect are rejecting a borrower because of an isolated credit difficulty or credit difficulties in the distant past; not including income from overtime or part-time work, or being overly restrictive on payment-to-income ratios when qualifying borrowers. These practices discriminate against minority and lower-income groups.

It was previously indicated that the institution can adjust the terms of the loan, if necessary, to avoid unsafe and unsound business practices. The act has spelled out further regulations in regard to this.

- ♦ Neighborhood considerations (such as characteristics or trends in the neighborhood, Location of the property in the neighborhood, etc) unless the institution can prove that such considerations are necessary to avoid unsafe and unsound business practices

Form 11-4: Fair Lending Notice (BRE Form 867)

THE HOUSING FINANCIAL DISCRIMINATION ACT OF 1977

FAIR LENDING NOTICE

It is illegal to discriminate in the provision of or in the availability of financial assistance because of the consideration of:

1. Trends, characteristics or conditions in the neighborhood or geographic area surrounding a housing accommodation, unless the financial institution can demonstrate in the particular case that such consideration is required to avoid an unsafe and unsound business practice: or
2. Race, color, religion, sex, marital status, domestic partnership, national origin or ancestry.

It is illegal to consider the racial, ethnic, religious or national origin composition of a neighborhood or geographic area surrounding a housing accommodation or whether or not such composition is undergoing change, or is expected to undergo change, in appraising a housing accommodation or in determining whether or not, or under what terms and conditions, to provide financial assistance.

These provisions govern financial assistance for the purpose of the purchase, construction, rehabilitation or refinancing of one- to four-unit family residences occupied by the owner and for the purpose of the home improvement of any one- to four-unit family residence.

If you have any questions about your rights, or if you wish to file a complaint, contact the management of this financial institution or the Department of Real Estate at one of the following locations:

2550 Mariposa Mall, Suite 3070
Fresno, CA 93721-2273

320 W. 4th Street, Suite 350
Los Angeles, CA 90013-1105

1515 Clay Street, Suite 702
Oakland, CA 94612-1462

2201 Broadway
P.O. Box 187000 (mailing address)
Sacramento, CA 95818-7000

1350 Front Street, Suite 3064
San Diego, CA 92101-3687

FEDERAL EQUAL CREDIT OPPORTUNITY ACT

The **FEDERAL EQUAL CREDIT OPPORTUNITY ACT** makes it unlawful for a creditor (lender) to discriminate against any applicant on the basis

of race, color, religion, national origin or ancestry, sex, marital status, or age (provided the applicant has a capacity to contract). The required disclosure is the Notice of Adverse Action.

ADVERSE ACTION

The denial, revocation, or change in the terms of an existing credit arrangement is an adverse action. It does not include a refusal to extend credit under an existing credit arrangement where the applicant is delinquent or otherwise in default. Nor does it include additional credit which would cause an extension of credit to exceed an already established limit.

APPLICATION

According to the law, any creditor who decides to deny an application for credit must provide the applicant with a statement of reasons, or a written notification of the applicant's right to obtain a statement of reasons.

- ♦ **Timing** - The statement of reasons may be given by the lender as a matter of course with the notice of adverse action. In most cases, this must be provided within **30 days after** receiving the completed loan application. For some types of credit transactions, this time limit is longer.

Some of the basic provisions of the act that affect real estate lenders are:

- ♦ If applicants request, lenders must consider information provided by the borrowers indicating that a bad history of a joint account does not reflect on their credit.
- ♦ Lenders cannot ask about birth control practices or childbearing intentions or capabilities.
- ♦ Lenders cannot ask if the borrower is divorced or widowed. They may ask if the borrower is married, unmarried, or separated. For purposes of the law, unmarried means single, divorced, or widowed.
- ♦ Lenders cannot ask about receiving alimony or child support unless the borrower is first notified that it need not be revealed. However, lenders may ask about obligations to pay alimony or child support.
- ♦ Lenders must notify applicants in writing within 30 days regarding action taken on their applications. In case of disapproval, the reason must be given.

CHAPTER 11 QUIZ

1. Federal Reserve Regulation Z is enforced by:

- A HUD
 - B The State Fair Employment Practices Commission
 - C The Federal Trade Commission
 - D None of the above
2. In general, the Truth in Lending Act applies to:
- A Creditors
 - B Advertisers of credit
 - C Discrimination involving credit
 - D Both "A" and "B"
3. The "Annual Percentage Rate" written in bold letters is required by the:
- A Truth in Lending Act
 - B Federal Reserve Regulation Z
 - C Federal Consumer Credit Protection Act
 - D All of the above
4. If the loan is secured by the borrower's residence, a borrower has the right to rescind before midnight of the third business day following consummation of a contract, with the **exception** of:
- A. A junior trust deed and note used to purchase an automobile;
 - B. A second trust deed given to the real estate broker to finance a college education;
 - C. A third trust deed and note given to a building contractor to pay for remodeling;
 - D. A first trust deed used to finance the purchase of an owner-occupied residence.
5. Federal Reserve Regulation Z:
- A. Never applies to real estate brokers.
 - B. Applies to all advertising of real estate brokers.
 - C. Applies to advertising of real estate brokers only if some of the available credit terms are given.
 - D. None of the above.
6. Disclosure requirements for purchase money credit extensions by sellers, or seller carryback situations, are prescribed by:
- A Regulation Z.
 - B California Civil Code.
 - C RESPA.

- D. All of the above.
7. RESPA prohibits:
- A. A seller insisting as a condition of sale, that the buyer use a particular title company.
 - B. The forced sale of a residence.
 - C. Claims against unsecured judgments.
 - D. A licensee from advising on a homestead issue.
8. Under the Equal Credit Opportunity Act, lenders are required to notify applicants what action has been taken within a reasonable time period not exceeding:
- A. Two weeks.
 - B. 30 days.
 - C. Three months.
 - D. Any time mutually agreed between borrower and lender.
9. The federal law designed to protect and inform homebuyers against unnecessary high closing costs is known as the:
- A. Equal Credit Opportunity Act.
 - B. Real Estate Settlement Procedures Act.
 - C. Uniform Settlement Statement.
 - D. Consumer Credit Protection Act.
10. The Holden Act primarily addresses:
- A. Sex and age discrimination.
 - B. Redlining.
 - C. Health and safety.
 - D. Variable rate disclosures.

*Chapter 11 Answers: 1-C, 2-D, 3-D, 4-D, 5-C, 6-A, 7-A, 8-B, 9-B,
10-B*

CHAPTER 12: QUALIFYING THE PROPERTY



PREVIEW

This chapter describes the procedures lenders use in qualifying or appraising a property for loan purposes: The neighborhood is analyzed, the property is inspected, and a value is determined so that a loan may be arranged. We also review use of an appraisal form in depth and list special considerations by lenders on planned unit developments and condominiums.

LOAN UNDERWRITING DECISIONS

There are two basic elements involved in determining the appropriate lending decision on residential real estate:

1. Determination of the value of the underlying collateral by means of an appraisal. This serves to determine the upper limit of loan advance.
2. Determination of the borrower's capacity to service the debt in a satisfactory manner. This upper limit of loan advance may remain the same or be lowered based upon the borrower's repayment ability.

QUALIFYING THE BORROWER

The prospective borrower must be qualified in terms of ability to repay the loan and willingness to repay (credit record.) Qualifying the borrower is discussed in the next chapter.

QUALIFYING THE PROPERTY

Real estate appraisers evaluate a neighborhood carefully because location has a great influence on the value of a property. Appraisers also pay

particular attention to the condition and quality of the property. It is important to note, however, that redlining is illegal.

- ♦ **Residential Property** - Lenders expect borrowers to use their expected to repay a loan on a personal residence. For a qualified borrower, the qualification of the property becomes significant in case the borrower's ability or willingness to pay should change. The property value must be adequate to provide a security for the loan. In a foreclosure, the sale of the property would be expected to bring in adequate funds to repay the debt.
- ♦ **Income Property** - For loans on income-producing properties, income of the property that is expected to repay the loan. The property must be evaluated not only as a security for the loan in the event of default, although that is an important consideration, but also in terms of sufficient income to repay the debt, in quantity and stability.

ESTIMATING VALUE USING APPRAISAL METHODS

PURPOSES OF APPRAISAL IN REAL ESTATE

Appraisal is defined as a supportable or defensible estimate of a property's value as of a particular time. Buyers, sellers, and lenders require such information in real estate transactions.

- ♦ **Lending** - Government regulatory agencies supervising the lending activities of banks, savings and loan associations, insurance companies, credit unions, pension funds, and other lending entities, usually require that a professional appraisal be prepared.
- ♦ **Basis for Decisions** - Lending institutions make underwriting decisions based on the data, analysis, and conclusions set forth in the appraisal. These underwriting decisions include:
 - The loan-to-value ratio or the amount to be loaned as a percentage of the property value.
 - The appropriate number of years over which to amortize the principal of the loan, based on value trends in the area and the age and condition of the property.
 - The appropriate interest rate, considering the lender's cost of money and the relative risk of suffering a loss through foreclosure of the loan.

ETHICS

The Real Estate Commissioner's Suggestions for Professional Conduct, a companion to the Code of Professional Conduct (Regulation 2875, Title 10, California Code of Regulation), encourages real estate licensees to "advertise or claim to be an expert in an area of specialization in real estate brokerage activity, e.g., appraisal, property management, industrial sitting, mortgage loan, etc., **only** if the licensee has had special training, preparation or experience."

USING A STANDARD APPRAISAL FORMS

For single-family residences, a form report is usually satisfactory. The government makes stringent requirements as to form and support in appraisals for loans where government insurance or guarantees are involved.

The form shown in Form 12-1 is the standard used by Fannie Mae and Freddie Mac (and since its adoption by the agencies, most lenders have come to use it as well), with some exceptions (e.g., lenders participating in FNMA's Desktop Underwriter program).

The appraisal form is divided into three basic sections: **neighborhood data**, or characteristics; **information on the property**; and **valuation**, as illustrated in Form 12-1.

ESTIMATE VALUE BY EACH OF THE APPRAISAL METHODS

There are three approaches used for appraisal, they are the sales comparison approach, the cost approach and the income approach. Occasionally, only one approach will be appropriate, because only limited data will be available for some properties.

SALES COMPARISON APPROACH / MARKET DATA APPROACH

MARKET DATA APPROACH or the **SALES COMPARISON APPROACH**, the sales prices of recently sold comparable properties are adjusted to derive an estimate of value for the property under appraisal.

The sales comparison or market data approach to appraising makes the most direct use of the **principle of substitution**. The appraiser finds three to five (or more) properties that have sold recently and are similar to the subject property. The appraiser notes any dissimilar features and makes an adjustment for each by using the following formula:

$$\text{Value of Subject Property} = \text{Sales Price of Comparable Property} \pm \text{Adjustments}$$

The appraiser adds to the sales price of a comparable property the value of a feature present in the subject property but not in the comparable. The appraiser subtracts from the sales price of the comparable property the value of a feature present in the comparable but not in the subject property. Major types of adjustments include those made for physical (on-site) features, locational (off-site) influences, conditions of sale (buyer-seller motivation and financing terms), and time from date of sale. After going through this process for each of the comparable properties, the appraiser assigns a value to the subject property that is the adjusted sales price of the comparable(s) most like the subject.

The two keys to effective use of the sales comparison approach are:

- ♦ Identifying similar properties that are truly comparable to the subject property,
- ♦ Making the proper adjustments to the sales prices of the comparable properties to account for any differences between the subject property and the comparables.

It is relatively rare to find two properties that are so comparable that there is no difference in their values. For this reason, the adjustment process is central to the sales comparison approach. In the adjustment process, the sales price of the comparable property is adjusted to reflect aspects of the comparable property that are viewed as more or less valuable in comparison to the subject property

Example:

House A, which sold for \$55,000, is comparable to house B, the subject property, but has a garage valued at \$5,000. House B has no garage. In this case, using the formula for the sales comparison approach, the market value of the subject property would be reached as shown below.

$$\begin{aligned} \$55,000 - \$5,000 &= \$50,000 \\ \text{House B is valued at } &\$50,000. \end{aligned}$$

Example:

House X, the subject property, is 15 years old. A comparable property, house Y, is 15 years old and sold for \$70,000 one year prior to this appraisal. Because of changes in market conditions since the sale of house Y, the appraiser has determined that 10 percent added to the sales price is an accurate reflection of the increase in property values over the year. In this case, using the formula for the sales comparison approach:

$$\text{Value of Subject Property} = \$70,000 + (10\% \times \$70,000) = \$77,000$$

House X is valued at \$77,000.

COST APPROACH

In the **COST APPROACH**, the cost of property improvements, less depreciation on improvements, is added to site value.

In the cost approach, the appraiser estimates the value of any improvements to the land (such as structures) in terms of their reproduction or replacement cost. The appraiser then subtracts any loss in value owing to the depreciation of the improvements. Finally, the appraiser adds an estimate of the value of the site itself, usually found by the sales comparison approach. The formula for the cost approach is:

$$\text{Property Value} = \text{Reproduction or Replacement Cost of Improvements} - \text{Depreciation Improvement(s)} + \text{Site Value}$$

Depreciation may occur through either *deterioration* (effects of wear and tear or the elements) or *obsolescence*. **Obsolescence** can be functional, such as outmoded room layout or design, or external, caused by changes in factors outside the property such as zoning, the property's highest and best use, or supply and demand.

Example:

A house being appraised is similar in size, design, and quality of construction to a new house that has a construction cost of \$125,000. The house being appraised has depreciated by 20 percent due to lack of maintenance and is on a lot valued separately at \$35,000. Using the cost approach formula:

Depreciation: $20\% \times \$125,000$

Property Value = $\$125,000 - \$25,000 + \$35,000 = \$135,000$

The estimated value of the property based on the cost approach is \$135,000.

Example:

A warehouse that would cost \$350,000 to construct today has depreciated 25 percent in its lifetime, and is on land valued at \$110,000. What is the property's total estimated value by the cost approach?

Property Value = $\$350,000 - (\$350,000 \times 25\%) + \$110,000$

$\$350,000 - \$87,500 + \$110,000 = \$372,500$

The estimated value of the property based on the cost approach is \$372,500.

METHODS OF COST ESTIMATION

In this approach to appraisal, value is estimated and analyzed by determining reproduction or replacement cost, less depreciation, plus the value of the land as if it were vacant.

The selection of a method of cost estimation depends upon the type of depreciation analysis to be made. The more detailed methods of depreciation analysis require more detailed estimates of cost. Several of the most widely used methods are presented below in increasing order of complexity and costliness.

- ♦ **Comparative Unit Method** - In this method, cost estimates are made by grouping all the components together on a *unit* basis, such as cost per square foot of building area or cost per cubic foot of building volume. This is the easiest method of cost estimation, and widely used in practice. However, it is the least accurate, because costs are averaged out over the whole building. Because incurable [?]physical deterioration can be estimated only on a lump-sum basis when this method is used, it cannot be used where a breakdown of the accrued depreciation estimate is required.
- ♦ **Unit-in-Place Method** -This method involves estimating the installed unit cost of materials or *component sections* of the structure. It accounts for the cost of both materials and the labor to put them in place, on a per unit basis. This method can be applied using the segregated cost data found in most cost manuals, with appropriate adjustments for time and location. An advantage of this method is that it simulates the procedures used by builders in preparing estimates, and is readily understandable, accurate, and widely used and accepted. However, it is detailed and time consuming.
- ♦ **Quantity Survey Method** - This is the most accurate method of cost estimation. It is also the most detailed, costly, and time-consuming, and should be attempted only by an expert. Due to the complexity of the method, its use is rarely justified in residential appraisal.

INCOME APPROACH

In the income approach, value is based on the rental income the property is capable of earning.

This income approach assumes that the value of property is indicated by the amount of income that the property can generate: the greater the income, the greater the value.

The income approach may use ***net operating income*** or *gross income*.

GROSS INCOME MULTIPLIERS (COMPARISON METHOD)

The use of gross income multipliers is an application of the market data approach. The **GROSS INCOME MULTIPLIER (GIM)** is a number which expresses the ratio between the sales price of a property and the gross rental income produced by that property at the time it is sold. Comparable sales properties for the gross income multiplier analysis are chosen in the same manner as sales comparables used in direct sales comparison analysis. The same salient features of the subject property which are accounted for in the direct sales comparison approach and the cost approach (location, physical characteristics, etc.) must be considered in the GIM analysis. At least six comparable sales properties should be included in the analysis; the use of 12 to 15 is preferable. The comparable sales must be bona fide, arm's length transactions. All sales data must be reliable and verified by one of the principals. .

Adjustments should not be necessary if the comparable properties are really comparable to the subject if adjustments are necessary, they should be made in the same proportion for both sales prices and rents. The appraiser must take care not to adjust the sales price for time, without making any corresponding change in the rent

There is no standard gross income multiplier. The GIM varies according to property type, market conditions, and time. The appropriate gross income multiplier is determined by current conditions in the local market

The gross income multiplier is derived by dividing the value of the property by its annual gross monthly income (GI).

The GIM for a specific property is usually not rounded, except perhaps to the nearest whole number. Rounding is more likely and properly applied to the multiplier selected during the reconciliation. Gross rent multipliers are not adjusted.

Reconciliation: If the properties are truly comparable to the subject and to one another, their gross income multipliers should fall within a fairly narrow range. The appraiser then selects the appropriate gross income multiplier indicated by the pattern for the comparable properties. This is the GIM that will be applied to the estimated market rent of the subject property to derive an estimate of value.

$$GIM = Value / GI \text{ or } Value = GI \times GIM$$

Example:

This process would be carried out for each rental sales comparable (six comparables in this case). From the above process, a range of multipliers would result.

Example: 13, 13, 14, 14.5, 14.5, 14.5, 15.0

From this example, we can see that 14.5 is the most likely multiplier.

If the monthly rent is \$2000, then the value would be:

$$\$2,000 \times 12 \times 14.5 = \$348,000.$$

Example

If the sales price is \$100,000 and the monthly rent is \$400, the Gross Income Multiplier is $\$100,000 / (400 \times 12) = 20.83$

DISADVANTAGES OF USING GROSS INCOME MULTIPLIER

GIM is relatively simple to use and easy to understand. It is widely accepted. However, there are limits to its application.

- ♦ Gross rent multiplier analysis depends on an active rental market for residential properties. It may not work if there is insufficient reliable data..
- ♦ Unusual market forces may distort the relationship between rents and sales prices. Rentals tend to be more sensitive to changes in the environment than owner-occupied properties; while a renter may leave on short notice, an owner usually cannot without financial loss. Sales prices are more sensitive to changes in zoning regulations, tax burden, and physical deterioration than rents are, especially where rent controls distort the relationship between rents and sales prices.
- ♦ It is not as accurate as using a net operating income (discussed below). The gross income does not account for adjustment on the income losses due to factors like vacancies, loss, or operating expenses.

INCOME CAPITALIZATION

While the direct sales comparison and cost approaches are applicable to all types of properties, income capitalization is applicable only to

investment real estate which is capable of producing income and where the motivation of the buyers is a return on investment including income tax considerations.

- ♦ **INCOME CAPITALIZATION** is the process of converting a series of anticipated future periodic installments of net income to their present worth or value. The use of income capitalization in real estate valuation is based on the premise that value is the present worth of anticipated or forecast future benefits in the form of money income.
- ♦ Income capitalization differs from gross income multiplier analysis (discussed below) in that net income, rather than gross income, is processed to a value estimate.
- ♦ Valuation is undertaken from the viewpoint of the typical informed investor and is based on the money income produced by the property. The market is stratified into comparable, competitive investments.
- ♦ **Investment Principles** - Investment analysis is a matter of determining who gets what, and when. It indicates the amount and timing of anticipated income, receipts, and expenses.
 - More is preferable to less for income. The reverse is true for expenses and capital outlays. The investor would prefer to receive \$5,000 rather than \$500 on an investment
 - Sooner is preferable to later for income. The reverse is true for expenses and capital outlays. Because a dollar received today is worth more than a dollar received a year from now, the investor prefers to receive income from the investment as soon as possible.
 - The investor's primary concern is to maintain capital intact. This is return of investment, and means that the entire amount of the original investment is returned to the investor.
 - The investor typically seeks a profit or gain on the investment, in addition to the return of deposit. This gain is referred to as the return on investment.
- ♦ The capitalization rate is a composite of the rate of return on the investment.

NET OPERATING INCOME

The **income capitalization approach** is based on the net income, or investment return that a buyer expects from the property. The price that the buyer will pay is determined by the probable return the property will yield from the investment.

Remember that the income capitalization approach is based on **net operating income**, which is usually expressed as an annual amount.

- ♦ Compute the net operating income (NOI) from a gross annual income a vacancy factor is subtracted to establish an **effective gross income**, from which annual operating expenses are subtracted to arrive at the projected future net operating income.

$$\text{Effective Gross Income} = \text{Gross Annual Income} - \text{Vacancy Loss}$$

$$\text{Net Operating Income} = \text{Effective Gross Income} - \text{Operating Expenses}$$

If a property's net operating income for the year is known, as well as the buyer's anticipated return for the investment (*capitalization rate*), value can be computed by using the following formula:

$$\text{Property Value} = \text{Net operating Income} / \text{Capitation Rate Example:}$$

A buyer wants a nine percent investment return. He is interested in a medical office building that produces a net operating income of \$22,500 per year. What would the buyer be willing to pay for the building?

$$\$22,500 / 9\% = \$250,000$$

The property value necessary to produce the expected net operating income is \$250,000.

The return that can be expected based on an estimated level of income and property value can be computed by using a variation of the basic income capitalization formula: $\text{Return} = \text{Income} / \text{Property Value}$

Example:

An investor estimates that a net operating income of \$39,600 can be received from a building that will require an investment of \$360,000. What is the investor's capitalization rate (return)?

$$\$39,600 / \$360,000 = .11$$

The expected return, based on the income alone, is 11%.

A buyer who has only a certain amount to invest and wants a specific rate of return from his investment would use another variation of the formula:

$$\text{Net Operating Income} = \text{Property Value} \times \text{Return} (I = V \times R)$$

Example:

To receive a 12 percent return from an investment of \$100,000, what would be the required net operating income of the purchased property?

$$\$100,000 \times 12\% = \$12,000$$

The net operating income would have to be \$12,000.

DETERMINING CAPITALIZATION RATE

The two most frequently used methods of deriving a capitalization rate are the comparative sales and band of investment methods.

COMPARATIVE SALES

The comparative sales method of deriving an appropriate cap rate is based upon an analysis of recent sales of comparable properties. The indicated capitalization rate is derived by dividing the net income from the property by its sale price.

Example:

An apartment building with an annual net income of \$75,000 recently sold for \$750,000. The indicated capitalization rate is 10%. ($\$75,000 / \$750,000 = .10$ or 10%)

BAND OF INVESTMENT

The **BAND OF INVESTMENT METHOD** derives a capitalization rate, a composite of the rates of return required by the lender and by the owner of the equity interest. The rate of return required by the lender reflects the relative attractiveness of the loan compared with alternate permitted investments for the lender's funds. Similarly, the equity component reflects the competitive alternate returns to equity, both before and after taxes.

- ♦ **Mortgage Interest Technique.** The capitalization rate is computed as a weighted average of the most probable mortgage terms and the return required by the equity investor.

Example:

Assume that a long-term loan of 70% of the property value is available at 9% interest, and investors require 12% interest on the equity. What is the capitalization rate?

Interest	Portion	Rate	Product
First Mortgage	.70 x	.09	=.063
Equity	.30 x	.12	=.036
Capitalization Rate			=.099 or 9.9%

In this example, the percentages are only for return on total property value. For appraisal use, a cap rate must also include a proper return of investment, reduced to cover improvements only, over their remaining economic life.

Example:

An 80:20 building-to-land ratio is 80% depreciable. Assume a 25-year remaining economic life, or 4% yearly depreciation rate. $80\% \times 4\% = 3.2\%$ weighted depreciation rate. Add the result to a desired rate of return on investment to derive an overall rate. The capitalization rates must provide for both returns (of and on) in realty appraisal.

- ♦ **Mortgage Constant Technique** -This technique uses mortgage constants rather than the nominal interest rates used in the mortgage interest technique. A mortgage constant is the total annual payment of principal and interest, with level payment amortization, expressed as a percentage of the initial principal amount of the loan. Constants are found in published financial tables. This technique uses a weighted average of the mortgage constant and the return on equity required by investors.
 - Use of the mortgage constant technique provides for recapture (return of the investment) in addition to the return on the investment.
 - This is the preferred method for arriving at an overall capitalization rate and is the one most used by both appraisers and investors. However, it assumes that the amortization of loan principal satisfies all of the capital recapture requirements.

Example

Assume a 75% loan for 25 years at 9.5% interest represents the prevailing financing terms. The mortgage constant for these figures is .104880. If investors require 12% return on equity, the capitalization rate is calculated as follows:

Interest	Portion	Rate	Product
First Mortgage	.75 x	.104880	=.0786
Equity	.25 x	.12	=.03
Overall Capitalization Rate			= .1086 or 0.86%

Mortgage Constant: The total annual payment of principal and interest on a mortgage with level payment amortization, expressed as a percentage of the initial principal amount of the loan.

RECONCILIATION

The appraiser must correlate and reconcile the estimated values for the final value estimate and decide what conclusions can be drawn from the volume of collected facts. The appraiser cannot simply average differing value estimates. The most relevant approach, based on analysis and judgment, receives the greatest weight in determining the estimate that most accurately reflects the value sought.

RELATIONSHIP OF APPROACHES

The three approaches to real estate appraisal require different types of information, which may include data on comparable nearby property sales (sales comparison approach), building cost (cost approach), and investment return (income capitalization approach.) The information will help determine which of the appraisal methods will be given the most validity in the appraiser's final estimate of the market value of the subject property.

As a general rule, the sales comparison approach is the most reliable with single-family residences; the cost approach is most reliable with non-income-producing property having a limited market or with special purpose properties; and the income capitalization approach is most reliable with income-producing property.

Most appraisals will require the use of more than one approach, especially when land value must be distinguished from building value. This is true when the cost approach is used to find building value. There are other instances when land value must be separated from building value, such as for tax valuation purposes. These will be discussed later in this book.

The next step in the appraisal process is to analyze the value indications from the three approaches to determine the best opinion of value. This can be either a single dollar figure or a range into which the value will most likely fall. The process the appraiser follows to do this is called reconciliation.

Proper analysis and reconciliation are essential to a good appraisal report. The use of accepted appraisal methods does not in itself produce a sound value estimate. It must be combined with good judgment on the part of the appraiser, as well as experience in gathering needed information and making thorough analyses and value interpretations of relevant data.

Each of the three approaches to value results in a separate indication of value for the subject property. In general, the greater the similarity among the three value indicators, the more reliable they are. However, it is very rare for all three value indicators to be identical. When the value

indicators are not identical, the appraiser must somehow forge the value indicators into one estimate of value. This process is called reconciliation.

RECONCILIATION is the process of analyzing the appraisal problem, selecting the most appropriate method of the three and giving it the most weight in determining the final estimate of value.

Reconciliation is the easiest process when the value indicators are very similar.

In that case, it is usually safe to assume that the value of the property lies somewhere between the lowest value indicators and the highest.

Example:

An appraiser arrives at the following value indicators:

Cost Approach: \$150,000

Market Approach: \$145,200

Income Approach: \$144,500

Since the value indicators are reasonably similar to each other, the value of the property is probably somewhere between \$144,500 (the lowest indicator) and \$150,000 (the highest indicator.)

However, the process of reconciliation is *not* a simple averaging of the three value indicators. In fact, there is no set formula at all for reconciling the values. The process relies entirely on the judgment and ability of the appraiser to arrive at the most reliable estimate of value.

A primary consideration in the reconciliation process is the relative reliability of the three value indicators, especially when there is a wide disparity between the three indicators. For this reason, the reconciliation process requires a thorough review of the complete appraisal process. The appraiser must review the reliability of the data, the logic and analysis applied to the data and the resulting value indicators.

In addition to reviewing and considering the reliability of the various value indicators, the appraiser will also consider the use of the appraisal. For example, all things being equal, more weight may be placed on the value indicated by the income approach in the case of an appraisal that will be used by an investor who is looking for income property. On the other hand, if the appraisal is being used to help the owner-occupant purchaser qualify for a home loan, the sales comparison data approach may be considered the most reliable.

PROCEDURE FOR QUALIFYING A PROPERTY

CONVENTIONAL LENDERS

Conventional lenders use a less formal process than the FHA or DVA in qualifying the property. Typically, the applicant completes a loan application and presents it to the lender. The applicant is referred to a loan officer, who asks questions about the property to see if it meets the lender's policy. The loan officer also discusses the possible loan terms, such as loan-to-value ratio, interest rate, term, and loan fee. If the requested loan meets the lender's loan policy, the loan officer asks an appraiser to inspect the property.

Conventional lenders use both staff and fee appraisers. Commercial banks and savings banks use primarily staff appraisers. Mortgage companies mostly use fee appraisers. After an appraisal is completed, it is reviewed by the lender, who checks the appraisal for accuracy and completeness. In addition, the lender determines whether to proceed with the loan request. With the completed appraisal in hand, the lender is in a better position to make this decision. The lender checks the value of the property to make sure it is high enough to grant the loan. If the loan requested is based on a \$480,000 sales price but the lender's appraisal is only \$450,000, the lender can make a loan based on the lower amount, but not on the greater. If the property is acceptable and the value high enough to grant the loan, the lender will continue processing the loan. The next step is to qualify the applicant. Later, a loan committee reviews both the property and the applicant, and makes the final decision on whether to grant the loan.

FHA AND DVA PROPERTY STANDARDS

FHA and DVA requirements differ from most conventional loan requirements.

The Federal Housing Administration and the Department of Veterans Affairs *insure or guarantee* loans. They do not operate like conventional lenders. They have minimum property standards that all properties have to meet. Beyond that, the FHA and the DVA have no specific property requirements. They do not adjust the loan-to-value ratio. If the property meets the minimum standards, it will be entitled to the maximum loan. Likewise, the interest rate is not affected by the property. Lenders' rates and points for FHA and DVA are entirely negotiable.

QUALIFYING FOR FHA AND DVA

The primary responsibility of the FHA and DVA is ensuring that a property meets their minimum property standards. In addition, they must establish a market value for the property. An FHA appraisal must be ordered

through an approved FHA lender (commercial banks, savings banks, and most mortgage companies are included). The lender orders an appraisal by completing an FHA appraisal request form. On receipt of the request, the FHA will assign it to an FHA-qualified fee appraiser, an independent appraiser who works with lenders and the public.

After the appraiser has inspected and appraised the property, a **conditional commitment** is issued. The "conditional" includes any other conditions that the FHA is requiring, such as termite work and repairs, all of which must be completed before FHA insurance will be issued. A copy of the conditional commitment is sent to the lender who ordered the appraisal.

The DVA operates in much the same way. A DVA appraisal is ordered by filling out an appraisal request form. The appraisal can be ordered by anyone, but in practice is usually ordered by a DVA-qualified lender. The appraisal request is sent to the DVA, which in turn gives it to an independent DVA qualified fee appraiser. The DVA uses fee appraisers for all its field work. It does have full-time staff appraisers who serve as reviewers and supervisors. Completed appraisals are sent to the DVA office for review. If approved, the next step is the issuance of a **Certificate of Reasonable Value (CRV)**, which also includes other conditions and repairs that the DVA requires on the property.

FINAL MARKET VALUE

Once the appraiser has completed the three approaches to value, the next step is to arrive at a final estimate of value. This process is called **final reconciliation**. The appraiser begins the process by analyzing the strengths and weaknesses of each approach to determine which approach will give the most reliable answer.

In the appraisal of single-family properties, more weight is given to the sales comparison or market approach because it is the most reliable. The cost approach is not as reliable because of the difficulty estimating depreciation and determining the value of land in a built-up neighborhood. The cost approach is best used for special-purpose properties such as churches, schools, government buildings, and anything other than private residences. The use of a gross income multiplier is seldom used in appraising a single-family property, because typical buyers do not buy them for income purposes.

Next, the appraiser analyzes the report data for completeness and reliability. The final step is to arrive at market value. Again, this is not an averaging process, but one in which the appraiser evaluates each approach, and then selects a single estimate of value.

TITLE INSURANCE

A preliminary title report examines the condition of title prepared in anticipation of closing and prior to issuance of a title insurance policy.

- ♦ **Who Owns What** - A lender accepting a security interest in real property has to be certain that the borrower has, and can convey to the lender an insurable interest in the property.
- ♦ **Lender's Coverage Required** - A lender's title requirements include protection against any problems that affect the value of the loan security.

TYPES OF POLICIES

There are two types of title insurance policies: the standard and the extended.

STANDARD TITLE POLICY (CLTA)

The standard policy is the most widely used, and generally:

- ♦ Insures the owner for the amount of the purchase price.
- ♦ Insures the lender for the amount of the loan.

Standard policy is frequently referred to as a CLTA (California Land Title Association), a state trade association for title insurance companies. This standard policy insures the lender only unless the owner requests and pays for owner coverage.

This policy protects against:

1. Matters of public record. Acknowledged documents are recorded in the county where the property is located. Sources for searching for documents are city, county, state and federal authorities, including:
 - ♦ Federal land offices.
 - ♦ State of California Secretary of State.
 - ♦ Taxing authorities.
 - ♦ Special assessment districts.
 - ♦ County Clerk's Office.
 - ♦ Anyone having an interest in due property.
2. Forgery.
3. Impersonation or lack of capacity of a party to a transaction. E.g., transaction with a minor.
4. Defective delivery of a recorded grant deed.

Under standard policy, the title company does not make a physical inspection of the property, and therefore excludes the following:

1. Unrecorded easements and liens, encroachments or rights of parties in possession.
2. Changes in land use dictated by zoning ordinances.
3. Mining claims and water rights.

EXTENDED POLICY (ALTA)

Other risks can be ascertained by an on-site inspection of the property and a survey. Extended coverage is established and normally required by lenders. If the owner wants additional perils covered, extended coverage or a special endorsement can be added.

An **ALTA extended coverage lender's policy** includes standard coverage provisions, plus:

- ♦ Incorrect survey of property boundary lines or size of lot.
- ♦ Violations of recorded covenants, conditions, and restrictions.
- ♦ Encroachments of improvements onto existing easements.
- ♦ Any unrecorded easement rights disclosed by inspection.
- ♦ The rights of other parties, possessory or otherwise, disclosed by inspection.
- ♦ Unrecorded leases of tenants occupying the land.
- ♦ Unrecorded assessments as disclosed by public works activity in the area and inspection of tax office records (if work is in progress).
- ♦ Unrecorded claims resulting from work performed or materials provided for recent improvement of the land.

The extended coverage policy is commonly referred to as an ALTA (American Land Title Association) policy. The ALTA policy, which includes a competent survey or physical inspection, is usually required by California and out-of-state lenders who are not able to make a personal, physical inspection of the property. The borrower pays for this policy.

☞ No policy will protect against defects known to the insured or against government regulations concerning occupancy and use (zoning.)

ALTA-R

The ALTA-R policy is recommended by title companies for one-to-four owner-occupied residential dwellings. It does not include a survey because the property lines are already established by a recorded

subdivision map. Since the title companies do not have to do a survey, it gives the buyer more coverage for the same price. The CAR deposit receipt includes the ALTA-R as the preferred residential title policy choice.

HAZARD INSURANCE

An insurance policy is a contract in which the insurer agrees to indemnify the insured against losses caused by an unknown or contingent event.

- ♦ **Lender's Risk** - If the value of a secured property is reduced by some event, the lender's security is proportionally diminished. The lender reduces this risk by requiring that it be named as the beneficiary in a risk insurance policy.
- ♦ **Perils Covered** - The lender will require insurance against loss not only by the hazards of fire and lightning, but also most likely the additional perils of windstorm, hail, aircraft, riot, vehicles, explosion, and smoke.

Form 12-1: Sample Uniform Residential Appraisal Report (partial - 3 pages)

REAL ESTATE FINANCE

Speedy Appraisal Services

UNIFORM RESIDENTIAL APPRAISAL REPORT

File No. 1462Saska

Property Description		1462 Saskatchewan Dr. City Sunnyvale State CA Zip Code 94087																																																					
Legal Description		Tract 3821, Lot 56 County Santa Clara																																																					
Assessor's Parcel No. 323-29-071		Tax Year 2001 R.E. Taxes \$ 6,854.38 Special Assessments \$ N/A																																																					
Borrower Chen Wen-Jei & Yu Ying L. Current Owner Same		Occupant: ☒ Owner ☐ Tenant ☐ Vacant																																																					
Property rights appraised ☒ Fee Simple ☐ Leasehold ☐ Project Type ☐ PUD ☐ Condominium (HUD/VA only) HOAS N/A /Mo.																																																							
Neighborhood or Project Name N/A		Map Reference 832-D4 Census Tract 5083.04																																																					
Sale Price \$ Refinance Date of Sale N/A		Description and \$ amount of loan charges/concessions to be paid by seller N/A																																																					
Lender/Client Chesapeake - EMail		Address 30030 Mission Blvd. # 216, Hayward, CA 94544																																																					
Appraiser Dynasty Appraisal		Address 4907 Colusa St., Union City, CA 94587																																																					
Location ☐ Urban ☒ Suburban ☐ Rural Built up ☒ Over 75% ☐ 25-75% ☐ Under 25% Growth rate ☐ Rapid ☒ Stable ☐ Slow Property values ☐ Increasing ☒ Stable ☐ Declining Demand/supply ☐ Shortage ☒ In balance ☐ Over supply Marketing time ☒ Under 3 mos. ☐ 3-6 mos. ☐ Over 6 mos.		Single family housing PRICE \$ (000) 400 Low 10 AGE (yrs) 1100 High 60 Predominant Commercial 2% 600 30																																																					
Predominant occupancy ☒ Owner 95% ☐ Tenant ☒ Vacant (0-5%) ☐ Vacant (over 5%)		Present land use % One family 95% ☒ Not likely ☐ Likely 2-4 family 2% ☐ In process Multi-family 1% Commercial 2%																																																					
Note: Race and the racial composition of the neighborhood are not appraisal factors. Neighborhood boundaries and characteristics: The subject neighbourhood is bounded by El Camino Real to the north, Interstate 280 to the south, Highway 85 to the west, Wolfe Rd. to the east. Factors that affect the marketability of the properties in the neighborhood (proximity to employment and amenities, employment stability, appeal to market, etc.): At this time, there are no factors affecting the marketability of neighbourhood properties. The subject property is located in southern area of City of Sunnyvale. Homes in the area are of good to average quality/construction and are displaying typical care and maintenance. The subject property is located in close proximity to Fremont High School, Homestead Hospital and Homestead Square. Interstate 280 approximately 3/4 mile south, offers good access to the employment area of South Bay. Market conditions in the subject neighborhood (including support for the above conclusions related to the trend of property values, demand/supply, and marketing time - such as data on competitive properties for sale in the neighborhood, description of the prevalence of sales and financing concessions, etc.): Concessions are not prevalent. Marketability for the area is good with reasonably priced listings selling within 1 to 3 months. Home values are stable over past couple months.																																																							
Project Information for PUDs (if applicable) - Is the developer/builder in control of the Home Owners' Association (HOA)? ☐ YES ☒ NO Approximate total number of units in the subject project N/A Approximate total number of units for sale in the subject project N/A Describe common elements and recreational facilities: N/A																																																							
Dimensions 94.78X85 Site area 8,056 Sq.Ft. Corner Lot ☐ Yes ☒ No Specific zoning classification and description R1 (Residential) Zoning compliance ☒ Legal ☐ Legal nonconforming (Grandfathered use) ☐ Illegal ☐ No zoning Highest & best use as improved: ☒ Present use ☐ Other use (explain)		Topography Basically Level Size Typical for area Shape Rectangular Drainage Appears adequate View None Landscaping Typical Driveway Surface Concrete Apparent easements None apparent FEMA Special Flood Hazard Area ☐ Yes ☒ No FEMA Zone BX Map Date 12/19/1997 FEMA Map No. 0603520001D																																																					
Comments (apparent adverse easements, encroachments, special assessments, slide areas, illegal or legal nonconforming zoning, use, etc.): No apparent adverse easements, encroachment or conditions noted.																																																							
GENERAL DESCRIPTION No. of Units One No. of Stories One Type (Det./Att.) Detached Design (Style) Ranch Existing/Proposed Existing Age (Yrs.) 37 Effective Age (Yrs.) 25		EXTERIOR DESCRIPTION Foundation Concrete Exterior Walls Stucco Roof Surface Asph. Sh. Gutters & Dwnspts. Gal Alum. Window Type Sld. Alum. Storm/Screens Thermo/Yes Manufactured House No																																																					
FOUNDATION Slab No Crawl Space Yes Basement N/A Sump Pump N/A Dampness None noted Settlement None noted Infestation None noted		BASEMENT Area Sq.Ft. 0 % Finished N/A Ceiling N/A Walls N/A Floor N/A Outside Entry N/A																																																					
INSULATION Roof Cncl'd ☒ Ceiling Cncl'd ☒ Walls Cncl'd ☒ Floor Cncl'd ☒ None ☐ Unknown ☐																																																							
<table border="1"> <thead> <tr> <th>ROOMS</th> <th>Foyer</th> <th>Living</th> <th>Dining</th> <th>Kitchen</th> <th>Den</th> <th>Family Rm.</th> <th>Rec. Rm.</th> <th>Bedrooms</th> <th># Baths</th> <th>Laundry</th> <th>Other</th> <th>Area Sq.Ft.</th> </tr> </thead> <tbody> <tr> <td>Basement</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>Level 1</td> <td>1</td> <td>1</td> <td>1</td> <td>1</td> <td></td> <td>1</td> <td></td> <td></td> <td>1</td> <td>1</td> <td></td> <td>1,265</td> </tr> <tr> <td>Level 2</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td>4</td> <td>2</td> <td></td> <td></td> <td>960</td> </tr> </tbody> </table>				ROOMS	Foyer	Living	Dining	Kitchen	Den	Family Rm.	Rec. Rm.	Bedrooms	# Baths	Laundry	Other	Area Sq.Ft.	Basement													Level 1	1	1	1	1		1			1	1		1,265	Level 2								4	2			960
ROOMS	Foyer	Living	Dining	Kitchen	Den	Family Rm.	Rec. Rm.	Bedrooms	# Baths	Laundry	Other	Area Sq.Ft.																																											
Basement																																																							
Level 1	1	1	1	1		1			1	1		1,265																																											
Level 2								4	2			960																																											
Finished area above grade contains: 9 Rooms; 5 Bedroom(s); 3 Bath(s); 2,225 Square Feet of Gross Living Area																																																							
INTERIOR Materials/Condition Floors Hd/Carpet/Good Walls Painted/Good Trim/Finish Wood Trim/Good Bath Floor Tile/Carpet/Good Bath Wainscot Fiberglass Doors Ext. Solid Wood In-Hollow Wood		HEATING Type FWA Fuel Gas Condition Avg. COOLING Central None Other None Condition																																																					
KITCHEN EQUIP. Refrigerator ☒ Range/Oven ☒ Disposal ☒ Dishwasher ☒ Fan/Hood ☒ Microwave ☐ Washer/Dryer ☐		ATTIC None ☐ Stairs ☐ Drop Stair ☐ Scuttle ☒ Floor ☐ Heated ☐ Finished ☐																																																					
AMENITIES Fireplace(s) # 1 ☒ Patio Concrete ☒ Deck Wood ☒ Porch Covered ☒ Fence Wood ☒ Pool None ☐		CAR STORAGE: None ☐ Garage 2 ☒ Attached 2 Cars Detached ☐ Built-in ☐ Carport ☐ Driveway 2Cars																																																					
Additional features (special energy efficient items, etc.): None																																																							
Condition of the improvements, depreciation (physical, functional, and external), repairs needed, quality of construction remodeling/additions, etc.: The subject property is in average physical condition. No physical, external or functional inadequacies were noted at time of inspection.																																																							
Adverse environmental conditions (such as, but not limited to, hazardous wastes, toxic substances, etc.) present in the improvements, on the site, or in the immediate vicinity of the subject property: There no adverse environmental condition were noted by the appraiser on the site, in the improvements, or the immediate vicinity at the time of inspection.																																																							

Pacific Mac Form 70 6-93

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Form No. 1004 6-93

REAL ESTATE FINANCE

Speedy Appraisal Services

UNIFORM RESIDENTIAL APPRAISAL REPORT

File No. 1462Saska

Valuation Section

ESTIMATED SITE VALUE		= \$	600,000
ESTIMATED REPRODUCTION COST-NEW OF IMPROVEMENTS:			
Dwelling	2,225 Sq. Ft. @ \$ 125.00	= \$	278,125
Bsm't. 0	Sq. Ft. @ \$	=	0
Patio		=	10,000
Garage/Carport	489 Sq. Ft. @ \$ 20.00	=	9,780
Total Estimated Cost New		= \$	297,905
Less 25 Physical	Functional	External	Est. Remaining Econ. Life: 50
Depreciation	\$83,466	= \$	83,466
Depreciated Value of Improvements		= \$	214,439
"As-is" Value of Site Improvements		= \$	20,000
INDICATED VALUE BY COST APPROACH		= \$	834,400

Comments on Cost Approach (such as, source of cost estimate, site value, square foot calculation and for HUD, VA and FmHA, the estimated remaining economic life of the property):
The high land to improvements ratio is typical of properties in this area. Costs were obtained from Marshall & Swift Handbook and local contractors. Land value is derived extraction. Depreciation determined by the overall condition of the unit as related to normal wear and tear and average condition of comparable residences in the area.

ITEM	SUBJECT	COMPARABLE NO. 1	COMPARABLE NO. 2	COMPARABLE NO. 3
1462 Saskatchewan Dr.	627 Oneida Dr.	650 Princeton Dr.	783 Steuben Dr.	
Address Sunnyvale, CA 94087	LP: \$ 869,000 DOM: 11	LP: \$ 850,000 DOM: 35	LP: \$ 869,000 DOM: 11	
Proximity to Subject	0.65 Mi	0.7 Mi	0.75 Mi	
Sales Price	\$ Refinance	\$ 861,000	\$ 868,000	\$ 869,500
Price/Gross Liv. Area	\$ 0.00	\$ 379.30	\$ 382.38	\$ 391.49
Data and/or Verification Sources	Appraiser Inspection	Win2Data/NDC/MLS# 214524 Doc # 16239853	Win2Data/NDC/MLS#206562 Doc # 16152676	Win2Data/NDC/MLS#207802 Doc # 16184304
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	DESCRIPTION	DESCRIPTION
Sales or Financing Concessions	N/A	Conventional None	Conventional None	Conventional None
Date of Sale/Time	N/A	04/30/2002 COE	03/13/2002 COE	03/29/2002 COE
Location	Suburban	Suburban	Suburban	Suburban
Leasehold/Fee Simple	Fee Simple	Fee Simple	Fee Simple	Fee Simple
Site	8,056 Sq.Ft.	6,000 Sq.Ft. +10,000	6,100 Sq.Ft. +9,000	7,954 Sq.Ft. +500
View	None	None	None	None
Design and Appeal	Ranch	Ranch	Ranch	Ranch
Quality of Construction	Average	Average	Average	Average
Age	37 Yrs.	37 Yrs.	36 Yrs.	26 Yrs. -10,000
Condition	Good	Average +20,000	Good/Average +10,000	Average +20,000
Above Grade	Total Bdrms Baths	Total Bdrms Baths	Total Bdrms Baths	Total Bdrms Baths
Room Count	9: 5: 3.00	9: 5: 3.00	10: 5: 3.00	9: 4: 2.50 +7,000
Gross Living Area	2,225 Sq.Ft.	2,270 Sq.Ft.	2,270 Sq.Ft.	2,221 Sq.Ft.
Basement & Finished Rooms Below Grade	0 Sq.Ft. None	0 Sq.Ft. None	0 Sq.Ft. None	0 Sq.Ft. None
Functional Utility	Standard	Standard	Standard	Standard
Heating/Cooling	Gas FWA	Gas FWA/No AC	Gas FWA/No AC	Gas FWA/No AC
Energy Efficient Items	Standard	Standard	Standard	Standard
Garage/Carport	2 Cars Att. Gar.	2 Cars Att. Gar.	2 Cars Att. Gar.	2 Cars Att. Gar.
Porch, Patio, Deck, Fireplace(s), etc.	1 Fireplace	1 Fireplace	1 Fireplace	1 Fireplace
Fence, Pool, etc.	Fence/No Pool	-10,000	Fence/No Pool	Fence/No Pool
APN #	323-29-071	201-28-001		
Net Adj. (total)	[X] + [] - \$	20,000	[X] + [] - \$	19,000 [X] + [] - \$
Adjusted Sales Price of Comparable	Gross: 4.6% Net: 2.3%	\$ 881,000	Gross: 2.2% Net: 2.2%	\$ 887,000 Gross: 4.3% Net: 2.0%

Comments on Sales Comparison (including the subject property's compatibility to the neighborhood, etc.): All comps are resales of similar design, age, quality, condition and appeal from subject's market area.
Most weight is given to comp # 1 with support from comp # 2, 3 and 4.

ITEM	SUBJECT	COMPARABLE NO. 1	COMPARABLE NO. 2	COMPARABLE NO. 3
Date, Price and Data Source for prior sales within year of appraisal	No prior sales within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data	No prior sales other than above within 12 months as per Win2Data

Analysis of any current agreement of sale, option, or listing of the subject property and analysis of any prior sales of subject and comparables within one year of the date of appraisal:
The appraiser is not aware of any sale, option or listing on the subject property within last 12 months at all.

INDICATED VALUE BY SALES COMPARISON APPROACH \$ 881,000

INDICATED VALUE BY INCOME APPROACH (If Applicable) Estimated Market Rent \$ N/A /Mo. x Gross Rent Multiplier N/A = \$ N/A

This appraisal is made [X] "as is" [] subject to the repairs, alterations, inspections or conditions listed below [] subject to completion per plans and specifications.
Conditions of Appraisal: No condition noted.

Final Reconciliation: Most emphasis is on the market comparison approach which considers area of similar properties within subject's neighbourhood. Cost approach is supportive. Income approach is not applicable.

The purpose of this appraisal is to estimate the market value of the real property that is the subject of this report, based on the above conditions and the certification, contingent and limiting conditions, and market value definition that are stated in the attached Freddie Mac Form 439/Fannie Mae Form 1004B (Revised 6/93).
(WE) ESTIMATE THE MARKET VALUE, AS DEFINED, OF THE REAL PROPERTY THAT IS THE SUBJECT OF THIS REPORT, AS OF June 22, 2002
(WHICH IS THE DATE OF INSPECTION AND THE EFFECTIVE DATE OF THIS REPORT) TO BE \$ 881,000

APPRAISER: Signature _____ Name Dynasty Appraisal Date Report Signed June 23, 2002 State Certification # _____ State CA Or State License # AT028604 State CA
SUPERVISORY APPRAISER (ONLY IF REQUIRED): Signature _____ Name Jerry Fung Date Report Signed June 23, 2002 State Certification # AR023677 State CA Or State License # _____ State

Freddie Mac Form 70 6-93

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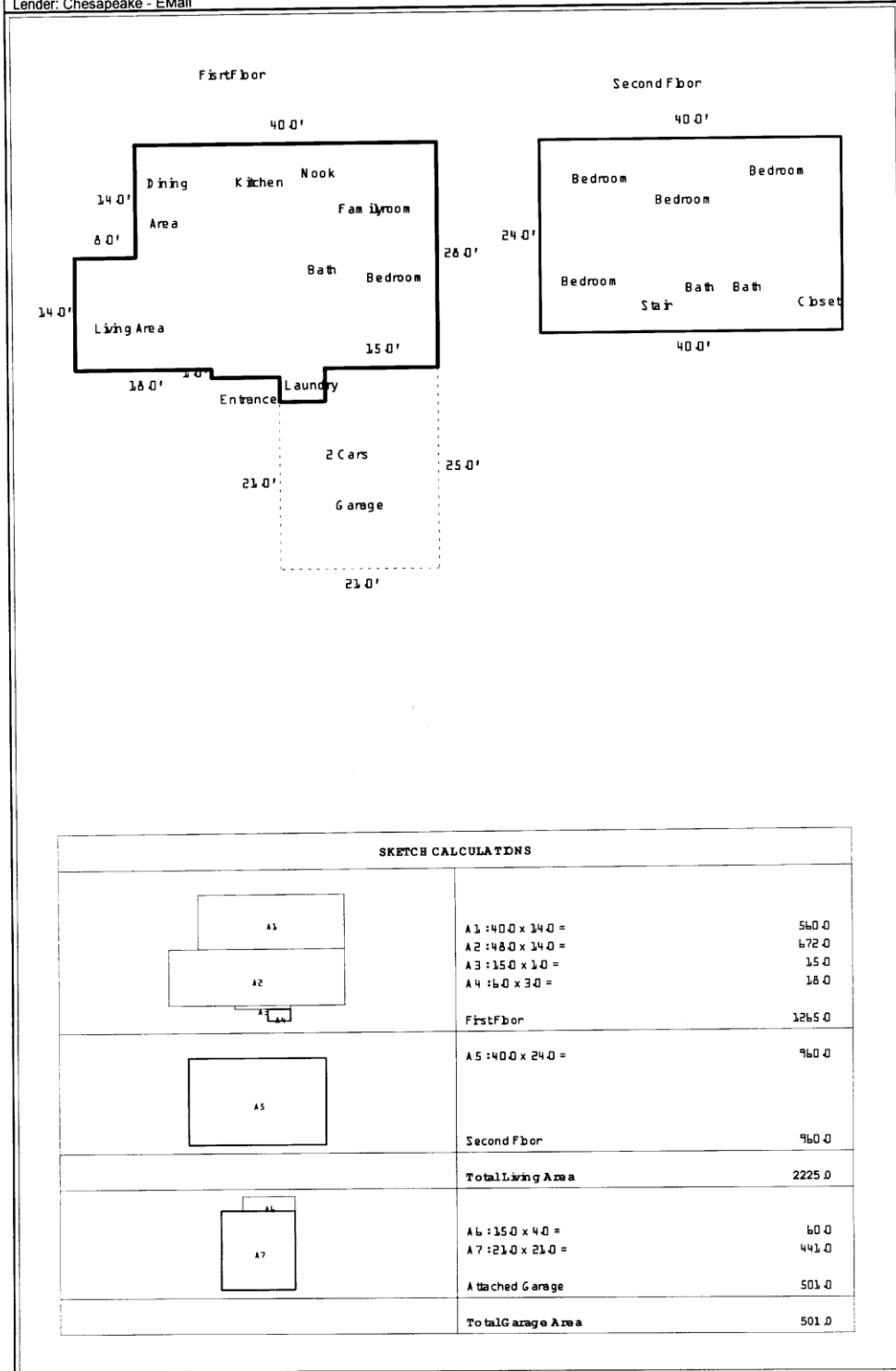
Fannie Mae Form 1004 6-93

Polaroid Digital Solutions, Inc.

REAL ESTATE FINANCE

FLOORPLAN

Borrower:	Chen Wen-Jei & Yu Ying L.	File No.:	1462Saska
Property Address:	1462 Saskatchewan Dr.	Case No.:	
City: Sunnyvale		State: CA	Zip: 94087
Lender: Chesapeake - EMail			



PLANNED UNIT DEVELOPMENTS AND CONDOMINIUMS

In recent years, many planned unit developments (PUDs) and condominiums have been built in the United States. As more are built and resales occur, it is important that you know what they are and how they are appraised. It is important because some lenders have different loan policies on PUDs and condominiums as opposed to single-family homes.

A PUD or condominium is a type of property ownership, not a type of structure. A PUD refers to separate, individual fee ownership of a lot and home or townhouse. In addition, you own a proportionately undivided interest jointly with others in the development of the common areas and recreational facilities, if any. It is sometimes called a townhouse development. The term *townhouse* refers to the architecture and not the type of ownership. A PUD could be a group of single-family homes if there were joint ownership of a common area. In a PUD, there is no one living in the "airspace" above anyone else.

A **CONDOMINIUM** is a type of development in which a person owns a specified residential unit (three-dimensional airspace), together with an undivided interest in all the land including recreational facilities. A condominium may be part of a high rise, attached townhouse, or even a single-family detached development. In a legal sense, a condominium owner acquires a fee title interest in the airspace of the particular unit and an undivided interest (with the other condominium owners) in the land plus all other common areas such as hallways, elevators, utility rooms, carports, and recreational facilities.

Both PUDs and condominiums have homeowner association groups that are responsible for the management of the development. These groups meet regularly and are governed by specific regulations. It is the association's responsibility to maintain the common areas. It also sets the dues that each owner must pay in order to maintain the common areas and the exteriors of the individual structures.

☞ PUDs and condominiums present special appraising and lending problems. Lenders are concerned about the entire project as well as the value of a single unit within the project.

A lender appraising a PUD or condominium unit is interested in more than just that particular unit. The lender is interested in the overall project, because the value of one unit is affected by the quality and the operation of the entire project. When a lender appraises a PUD or condominium, these are some of the items checked:

- ♦ General appearance of project
- ♦ Maintenance of common areas
- ♦ Amount of monthly homeowner dues, which should include reserves
- ♦ Recreational facilities that are adequate and well-maintained
- ♦ Adequate parking for owners and guests

A unit in a PUD or condominium is appraised basically the same way as a single-family dwelling. The appraiser uses the three approaches to value and relies primarily on the market data approach in arriving at a final value.

INTERNET WEB LINKS

www.arri-associations.org

American Society of Farm Managers and Rural Appraisers

www.orea.ca.gov

California Office of Real Estate Appraisers

www.iami.org/narea.html

National Association of Real Estate Appraisers

www.appraisalfoundation.org

The Appraisal Foundation

CHAPTER 12 QUIZ

1. Which of the following is the *easiest* method of cost estimation to understand and apply?
 - A Segregated costs
 - B Quantity survey
 - C Unit-in-place
 - D Square foot
2. The most detailed method of estimating cost *new* is the:
 - A. Quantity survey method
 - B. Unit-in-place method
 - C. Segregated cost method
 - D. Square foot method
3. The basic capitalization formula is:
 - A $V = I / R$
 - B $V = F / R$
 - C $V = I / F$
 - D $V = R / I$
4. Which of the following statements is correct?
 - A. A quantity survey estimate requires a separate calculation of building materials and labor
 - B. Square foot or cubic foot building costs are derived from local contractors, the analysis of recently constructed buildings, or cost manuals
 - C. Unit-in-place costs refer to the combined cost of material and labor to construct each functional unit of the structure
 - D. All of the above
5. A new house renting for \$1000 would sell for \$120,000. The gross income multiplier would be:
 - A. 120
 - B. 10
 - C. 150
 - D. 15
6. In reviewing the data collected for the income approach, the appraiser should check the mathematical accuracy of:
 - A. Gross income estimate

- B. Allowance for vacancy and collection losses
 - C. Operating expense estimate
 - D. All of the above
7. What is the most detailed and reliable method for estimating construction costs?
- A. Unit-in-place method
 - B. Quantity survey method
 - C. Asking the contractor
 - D. None of the above
8. The cost approach requires an estimate of the:
- A. Land value and
 - B. Site improvements and building costs
 - C. Depreciation allowance
 - D. All of the above
9. When using the Income Approach, the appraiser assumes that:
- A. Value is a function of income
 - B. Buyers estimate the duration of income when purchasing Income property
 - C. Future income is less valuable than present income
 - D. All of the above
10. Operating expenses of an apartment building may include all of the following, **except**:
- A. Salaries
 - B. Electricity
 - C. Management fees
 - D. Interest

*Chapter 12 Answers: 1-D, 2-A, 3-A, 4-C, 5-B, 6-D, 7-B, 8-D, 9-A,
10-D*

CHAPTER 13: QUALIFYING THE BORROWER



PREVIEW

The second step in undertaking the risk (rendering the underwriting decision) of lending money on the basis of residential real estate collateral is analyzing the borrower's qualification, applying guidelines established by the secondary market, FHA, VA, California Housing Agency as well as the financial institution's lending policies. The determination of what guidelines apply is dependent upon the type of financing sought by the borrower. Both information required for loan qualification and the various forms involved will be discussed in this.

Real estate licensees can spend considerable effort in showing homes to potential clients. If these clients have not been pre-qualified, this effort may be meaningless.

CREDIT AS MONEY

A prospective buyer with enough money can buy anything desired that is available. Very few people could buy real estate if it had to be bought with cash. The "qualified" homebuyer can buy with credit. Credit is a Latin-based word meaning "to trust" or "to believe." A banker lends money-- grants you "credit"--based on the belief that you will pay it back. Sometimes the money a banker loans you is "paper money" but usually it is "credit money" or "check money." We are all familiar with "check money"—a written instruction to your banker to pay money (paper or credit) to someone else. Throughout the entire series of complicated transactions it is customary that no actual money (paper money or coin) changes hands. It is all handled by the accounting activities of the bank(s.) From the consumer's viewpoint, credit is like money. Both confer power to purchase goods and services. Lacking money, a consumer who has credit can nevertheless buy today. Credit and credit rating will be discussed in more detail later in this chapter.

THE FINANCING CONTINGENCY

It has been estimated that approximately 99 percent of real estate purchase contracts contain financing contingencies. A buyer making an offer describes in some detail the financing proposed, and conditions the offer upon obtaining financing within the limits described. Typically, the buyer agrees "to act diligently and in good faith to obtain all applicable financing." If the proposed financing is not available, the contingency fails and the entire contract falls.

DEPOSIT RECEIPT

Form 13-1 is a portion of the first page of a CAR standard form deposit receipt available for use throughout California, identifying financing contingencies.

Form 13-1: California Residential Purchase Agreement (page 1)

REAL ESTATE FINANCE



CALIFORNIA
ASSOCIATION
OF REALTORS®

RESIDENTIAL PURCHASE AGREEMENT AND JOINT ESCROW INSTRUCTIONS

(C.A.R. Form RPA-CA, Revised 12/15)

Date Prepared: _____

1. OFFER:

A. THIS IS AN OFFER FROM _____

("Buyer").

B. THE REAL PROPERTY to be acquired is _____

, situated in _____

(City), _____ (County), California, _____ (Zip Code), Assessor's Parcel No. _____

("Property").

C. THE PURCHASE PRICE offered is _____

Dollars \$ _____

D. CLOSE OF ESCROW shall occur on _____ (date)(or) _____ Days After Acceptance).

E. Buyer and Seller are referred to herein as the "Parties." Brokers are not Parties to this Agreement.

2. AGENCY:

A. DISCLOSURE: The Parties each acknowledge receipt of a ☒ "Disclosure Regarding Real Estate Agency Relationships" (C.A.R. Form AD).

B. CONFIRMATION: The following agency relationships are hereby confirmed for this transaction:

Listing Agent _____ (Print Firm Name) is the agent of (check one):

☐ the Seller exclusively; or ☐ both the Buyer and Seller.

Selling Agent _____

(Print Firm Name) (if not the same as the

Listing Agent) is the agent of (check one): the Buyer exclusively; or the Seller exclusively; or both the Buyer and Seller.

C. POTENTIALLY COMPETING BUYERS AND SELLERS: The Parties each acknowledge receipt of a ☒ "Possible Representation of More than One Buyer or Seller - Disclosure and Consent" (C.A.R. Form PRBS).

3. FINANCE TERMS: Buyer represents that funds will be good when deposited with Escrow Holder.

A. INITIAL DEPOSIT: Deposit shall be in the amount of _____ \$ _____

(1) Buyer Direct Deposit: Buyer shall deliver deposit directly to Escrow Holder by electronic funds transfer, ☐ cashier's check, ☐ personal check, ☐ other _____ within 3 business days after Acceptance (or _____);

OR (2) ☐ Buyer Deposit with Agent: Buyer has given the deposit by personal check (or _____) to the agent submitting the offer (or to _____), made payable to _____.

_____ The deposit shall be held uncashed until Acceptance and then deposited with Escrow Holder within 3 business days after Acceptance (or _____).

Deposit checks given to agent shall be an original signed check and not a copy.

(Note: Initial and increased deposits checks received by agent shall be recorded in Broker's trust fund log.)

B. INCREASED DEPOSIT: Buyer shall deposit with Escrow Holder an increased deposit in the amount of _____ \$ _____ within _____ Days After Acceptance (or _____).

If the Parties agree to liquidated damages in this Agreement, they also agree to incorporate the increased deposit into the liquidated damages amount in a separate liquidated damages clause (C.A.R. Form RID) at the time the increased deposit is delivered to Escrow Holder.

C. ☐ ALL CASH OFFER: No loan is needed to purchase the Property. This offer is NOT contingent on Buyer obtaining a loan. Written verification of sufficient funds to close this transaction IS ATTACHED to this offer or ☐ Buyer shall, within 3 (or _____) Days After Acceptance, Deliver to Seller such verification.

D. LOAN(S):

(1) FIRST LOAN: in the amount of _____ \$ _____

This loan will be conventional financing or ☐ FHA, ☐ VA, ☐ Seller financing (C.A.R. Form SFA), ☐ assumed financing (C.A.R. Form AFA), ☐ Other _____ This loan shall be at a fixed rate not to exceed _____ % or, ☐ an adjustable rate loan with initial rate not to exceed _____ %.

Regardless of the type of loan, Buyer shall pay points not to exceed _____ % of the loan amount.

(2) SECOND LOAN in the amount of _____ \$ _____

This loan will be conventional financing or ☐ Seller financing (C.A.R. Form SFA), ☐ assumed financing (C.A.R. Form AFA), ☐ Other _____ This loan shall be at a fixed rate not to exceed _____ % or, ☐ an adjustable rate loan with initial rate not to exceed _____ %. Regardless of the type of loan, Buyer shall pay points not to exceed _____ % of the loan amount.

(3) FHA/VA: For any FHA or VA loan specified in 3D(1), Buyer has 17 (or _____) Days After Acceptance to Deliver to Seller written notice (C.A.R. Form FVA) of any lender-required repairs or costs that Buyer requests Seller to pay for or otherwise correct. Seller has no obligation to pay or satisfy lender requirements unless agreed in writing. A FHA/VA amendatory clause (C.A.R. Form FVAC) shall be a part of this Agreement.

E. ADDITIONAL FINANCING TERMS: _____

F. BALANCE OF DOWN PAYMENT OR PURCHASE PRICE in the amount of _____ \$ _____ to be deposited with Escrow Holder pursuant to Escrow Holder instructions.

G. PURCHASE PRICE (TOTAL): _____ \$ _____

Buyer's Initials (_____) (_____)

Seller's Initials (_____) (_____)

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CALIFORNIA RESIDENTIAL PURCHASE AGREEMENT (RPA-CA PAGE 1 OF 10)

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WHY PREQUALIFY THE BUYER?

Many real estate salespersons wait for the lender to qualify the borrower (after the buyer has selected a home to purchase) and hope that their buyer will qualify for the loan. The real estate professional in his first visit with the buyer can gather information that will aid the professional in qualifying the prospective buyer. This is a help not only to the real estate salesperson, but also to the buyer. The buyer will have a better idea of the maximum mortgage amount that he can support with his or her present income.

Once the maximum mortgage is established and the buyer has determined the amount of money available for a down payment, the maximum sales price of a home that the prospective buyer can afford can be calculated. To establish the maximum sales price, the maximum loan amount and the amount of down payment are added together. For example, in your meeting with a prospective buyer, you learn that the maximum conventional loan your buyer can afford is \$200,000 and he or she has \$25,000 for the down payment. The maximum sales price is \$225,000. Explain to the buyer that the maximum loan amount is based on the current guidelines of the lenders in the area, not just your own guidelines, and for the prospective buyer to afford a home with a higher sales price, he must either make a larger down payment or be able to establish the existence of additional income that will meet the lender's guidelines.

In addition to knowing the maximum house price before seeing any property, the prospective homebuyer will be familiar with the methods the lenders use to establish whether the buyer qualifies for the mortgage. If you take time to determine the maximum mortgage the buyer can qualify for *before* you begin showing any properties, you can avoid headaches for both you and your buyer. Many times the buyer will tell you a desired price range without really knowing how much home he can actually afford.

QUALIFYING THE BUYER

Real estate is expensive, almost always requiring a loan for its purchase. Such loans are usually long-term commitments for both buyer and lender. Naturally, lenders want certainty that both the property and the borrower make the loan a good risk. Since the savings and loan debacle of the 1980s, lenders have become considerably more diligent in qualifying the buyer and the property.

When a lender qualifies a borrower, it analyzes two general areas:

1. **Income or Ability to Pay** - As a general rule, to qualify for a home loan, lenders prefer that the amount of the borrower's monthly payment for shelter (including homeowners' association dues, insurance, taxes, principal and interest, etc.) not exceed 30 percent to 35 percent of borrower's monthly gross income. However, today the ratio of payments to income may often be higher.
2. **Desire or Willingness to Pay** - A person may have the ability to pay but lack the desire or willingness to do so. The desire to pay is just as important, but more difficult to measure. Lenders use a number of methods to determine a person's desire, discussed later in the chapter.

Each of these two areas will be examined in detail. It should be emphasized that qualifying a borrower is not a strict, precise operation. It is a process in which flexibility and judgment are key. There are rules used to qualify borrowers, but they are merely flexible guidelines. Each borrower is qualified on a case-by-case basis, and all aspects of the loan must be weighed before a decision can be made.

Some additional factors outlined below that lenders consider for approving a loan. Each will be discussed in detail.

- ♦ **Stability** - Stability and consistency of the borrower's income sources for the preceding two to three years is one of the lender's primary concerns.
- ♦ **Secondary Income** - Consistent overtime, bonuses, part time employment, DVA benefits, alimony and child support, etc., are included in gross income. Borrower must be able to verify these sources of income.
- ♦ **Debt Payment to Income** - Generally, lenders prefer all monthly payments of debts (longer than 8-10 months), including housing expense, not to exceed 33-36 percent of borrower's monthly gross income. However, this rule varies from institution to institution.
- ♦ **Down Payment** - From a lender's viewpoint, the larger the down payment, the less likely the borrower is to default on the payments.
- ♦ **Buyer's Credit** - Even though the property value is the lender's main security, emphasis on the borrower's ability to repay a loan is increasing.
- ♦ **Title Insurance** - In California, lenders almost always require title insurance on a property, to assure them of protection from any prior encumbrances or rights of others that could adversely affect the position of the lender and/or borrower.

INCOME/ABILITY TO PAY

Whether the borrower earns enough to make the monthly payments is the first consideration in determining the applicant's **ability** or **capacity to repay the loan**. There is no one answer because various lenders use different formulas, depending upon the type of loan. Conventional lenders, FHA, DVA, and Cal-Vet each have distinctive methods of qualifying a borrower.

TYPES OF INCOME

There is no question that income from regular employment is included, but do lenders count income from overtime, part-time work, or sales commissions? To be counted as stable, income must normally be earned in the same or similar occupation for at least two years. This section covers how lenders examine a variety of income sources.

- ♦ **Salaries** - This type of income is the easiest for buyers to establish and for lenders to verify. A prospective homebuyer who is employed by a company or corporation is usually paid a specific amount on a regular basis. The pay period can be weekly, biweekly, monthly, or bimonthly. This type of income is considered the most stable. If the prospective homebuyer is married and the spouse is employed, the income from the spouse will also count if the spouse has met the employment pattern and stability requirements of the lender. In the past, many lenders would discount, or in some cases eliminate, the salaried income of a woman if she was capable of having children, no matter what her profession or how long she had been employed. This practice was stopped with the passage of the Equal Credit Opportunity Act, and lenders are no longer allowed to discount income due to sex, age, or marital status.
- ♦ **Overtime** - This type of income is standard to many jobs and can be counted toward the prospective homebuyer's stable monthly income. It must be demonstrated that the income has been regular in the past and that chances are good that it will continue in the future. To establish that the overtime income has existed in the past, the prospective buyer may wish to supply copies of paycheck stubs to the lender showing the overtime hours worked in the past year. To establish whether the overtime will continue, the mortgage lender will, when verifying the income of the applicant, ask the employer to state if there is a possibility of the overtime continuing.

Lenders are reluctant to include overtime because, in most cases, it is not consistent and dependable. If borrowers can prove that they will continue to work overtime in the future, lenders will consider overtime pay. A good example is a police detective, since such work consistently requires overtime due

to the nature of the job. Other examples include firefighters, grocery clerks, truck drivers, and utility company employees.

- ♦ **Commissions** - If the prospective homebuyer is paid by commissions only, or is self-employed, lenders may require much more information. Usually, this includes either an acceptable profit-and-loss statement and balance sheets for the preceding two years, or complete copies of signed federal income tax forms from the previous two years. If the homebuyer is self-employed and has recently formed a new company, many lenders require the information outlined above and current financial statements on the business, as well as verification of the employment of the homebuyer for the previous two years. A person on straight commission or royalty income for less than two years will have a difficult time securing a mortgage, in particular if the prospective buyer is a real estate salesperson on a straight commission basis. Some commissioned people incur expenses that are not reimbursed by the employer. These expenses must be subtracted from income to arrive at a true income figure. Lenders require income tax returns from commissioned people to verify incomes.
- ♦ **Self-Employed** - A self-employed borrower must supply the lender with a balance sheet and profit-and-loss statements for the business, usually to the end of the most recent quarter. A balance sheet shows the assets, liabilities, and **net worth** of the business. Profit and loss statements must be provided for the last two years; some lenders require as many as three years. The borrower's income is based on these statements if it appears that the business will continue to produce the same level of income. Profit-and-loss statements should be carefully analyzed to arrive at a true net income figure. For example, depreciation on real estate is shown as an expense. Since it is not a cash expense, it can usually be added to net income. Capital gains taxes must be deducted. In addition, copies of income tax returns filed for at least two years are required.
- ♦ **Bonus** - Bonus income can also be included in the establishment of the monthly stable income, if the prospective buyer can establish a pattern of payments of the bonus for at least the past two years. This can be done by supplying copies of Internal Revenue Form 1099 if no deductions were withheld from the bonus, or Internal Revenue Form W-2 if there were deductions made for social security and income taxes. The employer will be asked if there is a possibility that the payment of bonus will continue.
- ♦ **Part-Time Work** - At one time, earnings from part-time work were not counted by lenders. For example, if a borrower works only 20 hours a week, the income must be counted if the job is stable.

☞ *The Federal Equal Credit Opportunity Act specifically prohibits lenders from discounting income solely because it is part-time.*

- ♦ **Second Job** - Since more and more people have second jobs, lenders are accepting it as part of the stable monthly income if the prospective home-buyer can establish that the job has existed for at least two years and that the possibilities are good for the job to continue. An example of an acceptable buyer with a second job would be a police officer who in off-duty hours has served as a security guard in several banks for the past 3 years. Since this type of second job is in the same field of work and the demand for security in banks is growing, the second job would not only provide extra money, but would be considered by lenders to be stable employment with excellent chances for continuing.
- ♦ **Dividend or Interest Income** - This type of income can be counted if it is at least \$100 per month and the investment is such that it cannot be sold or cashed in easily. This is true if the dividend or interest income is not the primary source of income. If the dividend or interest income is the primary source of the homebuyer's income, the lenders are going to require the homebuyer to show the source of income. If the income is derived from stocks, the lender will request either copies of the stocks or a statement from the brokerage firm that is holding the stock as to the actual ownership of the stock and a summary of the stock performance for the past several years. If the income is from interest, the lender will ask the source of income. The lender may request copies of the certificates of deposit or a statement from the bank or institution holding the CDs as to ownership and the amount of interest paid, as well as signed tax returns for the past several years.
- ♦ **Tradespeople** - Tradespeople such as carpenters and painters are treated basically the same as commissioned salespeople. The lender determines the previous two years' income by means of W-2 forms or tax returns. Hourly rates are not used because employment may not have been regular and full-time during the year.
- ♦ **Rental Income** - Rental income can be counted toward the stable monthly income, but many lenders give this type of income special consideration. On many applications, the lenders provide space for rental income to be included, but require the prospective homebuyer to provide the following information:
 1. The gross rental income from the property
 2. The amount of the mortgage payment on the property
 3. The amount of the taxes on the property
 4. A realistic set of operating expenses for the property

Lenders consider positive cash flow, or spendable income from real estate as income. Cash flow is gross income less mortgage payments, taxes, and operating expenses. Generally, an investment in a single-family dwelling shows little or negative cash flow. A negative cash flow is regarded as a long-term debt rather than a reduction of income.

When a person wishes to buy and occupy a unit in a two-, three-, or four-unit building, the question is: Does the income from the other units count? The answer varies by lender. The typical lender will count the income after subtracting a realistic figure for expenses and vacancy factor. The DVA includes the same income except for one condition: the veteran must have enough cash reserve to be able to absorb from three to six months of payments to cover the likelihood of vacant units. The reason for this is that the DVA has found that most foreclosures on two- to four-unit buildings occur in the first year.

- ♦ **Child Support Or Alimony Payments** - This type of income can be included in the determination of the stable monthly income if the applicant or co-applicant *so wishes*. Most lenders will review the payment of such monies in regard to the following items:
 - Are the payments made as a result of a court order?
 - What is the length of time the payments have been made?
 - How regularly have payments been made? This is accomplished by providing copies of canceled checks or verification of bank deposits.
 - What measures are available to demand payment if they are missed?
 - What are the ages of the children? Are the children all young and are the payments to be made for several years or are the children near the age of consent?

Under the Federal Equal Credit Opportunity Act borrowers are not required to reveal such income, and lenders cannot ask about income from either child support or alimony. However, a lender can ask about *payment* of child support or alimony for long-term debt purposes.

- ♦ **Welfare Income** - This type of income may be counted by the prospective homebuyer if it is to be used as part of the income for repayment of the mortgage. In the past, most lenders discounted or disallowed this type of income as part of the stable monthly income, but this practice was stopped with the passage of the Equal Credit Opportunity Act. These payments, as with any other income, will be verified by the lender as to their amount and frequency.
- ♦ **Retirement Income** - Since the age of the borrower cannot be used as a criterion for the granting of mortgages, more people are buying homes with the intention of retiring and financing the dwelling based on retirement income and personal savings. Income

- from social security and other pensions or trust funds can be used to establish the stable monthly income.
- ♦ **Pensions and Social Security** -Income from pensions and Social Security are counted if such sources are expected to continue on a steady basis. Copies of pension plans are required.
 - ♦ **Military Personnel** - Military personnel receive supplemental pay for quarters, clothing, and rations in addition to their base pay. When qualifying someone in the military, all of these extras are added to arrive at the true income. In addition, lenders take into account that military personnel receive free medical care and other services.

STABLE MONTHLY INCOME

After a lender has determined whether a borrower has a sufficient income, the next step is analyzing the stability of that income.

A **STABLE MONTHLY INCOME** is defined as "the borrower's gross monthly income from primary employment base earnings, plus recognizable secondary income" that is reliable and likely to endure.

To accomplish this, lenders look at such things as:

- 1 **Employment Pattern** - First, you must establish the employment pattern of your prospective buyer. Has the person been a job-hopper, jumping from one type of work or profession to another for no apparent reason? Lenders look for a pattern of full employment and job changes that improve the applicant's and co-applicant's careers.
- 2 **Employment Stability** - A second factor is employment stability-not only the stability of employment in the past, but the potential for future employment. When qualifying your buyer as to the stability of income, you should establish how long the prospective buyer has been employed in his present line of work and how long your buyer has been at his present job. Most conventional lenders have established a minimum of two years in the buyer's present line of work, with no minimum time on the present job. It should be noted that the important factor is the time in the present line of work.
For example, a prospective buyer has for the past several years been a lumber salesperson to the construction industry in Northern California and due to the slowdown in construction in that area decided to move to Los Angeles to seek better opportunities. In Los Angeles, the prospective buyer was not able to get a job selling lumber to the construction industry, but was able to get a job

- selling appliances in a retail store. According to most lenders, the prospective buyer has not changed his or her line of work--sales.
2. **Type of Job** - In addition to the length of employment, the type of job or profession is important. For example, a person who is highly skilled and with good qualifications, such as an MBA graduate from UC Berkeley will always be in demand and will have little worry in finding employment. Today, with advances in computer technology and the ever-expanding use of computers in industry, a person trained in computer science also will not have a problem finding employment. Other people thought to have stable employment are government employees, engineers, and other skilled people employed by large corporations. Examples of non-stable jobs include carpenters, painters, roofers, other construction workers and even loan brokers or appraisers. No one working in the construction industry can be sure of the length of his or her job, since it is so cyclical. Self-employed borrowers are also carefully scrutinized to determine their income stability. Lenders look at the length of time they have been in business, the net income, financial condition of the business, and the general prospects for the particular type of business.
3. **Age of the Borrower** - An applicant's age was once thought to affect the stability of income. Today, with the passage of federal anti-discrimination legislation, the age of the applicant cannot be used as a factor to establish the stability of the applicant's income..

☞ Age is no longer a factor.

SOURCE OF FUNDS FOR DOWN PAYMENT AND CLOSING COSTS

After the employment pattern and income of the prospective homebuyer is established, the next major item to be determined is the source of funds for the down payment and closing. This information is necessary not only to establish the maximum house price, but to provide it for the lender who will ask the prospective home-buyer to supply it. There are two basic sources of the funds: from cash on hand (bank accounts) or from the sale of property.

If the source is either a savings or checking account, the lender verifies with the bank or financial institution the date the account was opened and the average balance for at least the past 60 days. If the balance has seen a dramatic increase in the past sixty days, the lender will ask the prospective homeowner to explain the source of the additional funds. If the additional funds are a gift from the parents of an applicant, the lender will require a gift letter from the party giving the money. If the additional

funds are from a bequest from a will, a copy of the will and a letter from the administrator of the estate may be required.

If the additional cash is due to the sale of property and is so stated at the time of the application or in the initial meeting, the prospective homebuyer will be required to provide the lender with a copy of the earnest money contract if the transaction has not closed. If the transaction is closed, or upon closing, the prospective homebuyer must provide the lender with a copy of the closing statement, showing the proceeds to the seller and signed by all parties to the transaction. Some lenders require a copy of the seller's proceeds check and a copy of the deposit slip.

CO-BORROWING

What effect do multiple borrowers have on an application for a real estate loan?

The technical name lenders give a sole borrower is mortgagor. If there is more than one borrower, we have **co-mortgagors** (often husband and wife), sometimes called co-borrowers. Co-mortgagors sign the note and deed of trust and go on the title together. It should be noted that **co-signers** are not the same as co-mortgagors: Co-signers sign the note as guarantors but are not on the title, do not sign the trust deed, and therefore are rarely acceptable to real estate lenders. Co-mortgagors help with income qualifying but will not help overcome bad credit.

Lenders include all income and debts from all parties to qualify for the loan. If one or more of the co-mortgagors is not planning to occupy the home, then things can get complicated. Some lenders insist that all co-mortgagors occupy the home or they will deny the loan. Others try to work with the parties by counting some of the non-occupying co-mortgagor's income after deducting the co-mortgagor's own housing expenses and other monthly debts. Some require the non-occupying co-mortgagor to be a close relative. Fannie Mae and Freddie Mac dropped the close relative requirement, but insist that the co-mortgagor not be the seller, builder, real estate broker, or any party who has an interest in the sales transaction. The issue of non-occupying co-mortgagor is fluid and constantly changing, and it is difficult to give any definitive guidelines.

DESIRE TO PAY

This emotional aspect is closely related to the income of the prospective homebuyer. Many of your prospects may be marginal in their ability to pay simply based on a mathematical analysis of their income. They may, however, have the desire to pay and are willing to make sacrifices in order to buy a home.

How does a lender determine a borrower's *desire*? Let's look at some indicators.

- ♦ **Payment History** - How a borrower has paid debts in the past is a good indication of what can be expected in the future. If borrowers have paid on time in the past, they will likely continue to do so. If they had problems paying debts in the past, chances are that they will have problems in the future. People develop specific credit patterns. Lenders are interested in the overall pattern and are not concerned about one or two isolated slow payments. Lenders usually ignore the one slow payment if a borrower's overall credit rating is good. The one slow payment is probably an error in rating or may even be a disputed bill. Some buyers are concerned about a problem they may have had with one creditor. They are afraid one bad rating will ruin their chances for a loan. This is not true. Most lenders will accept a valid explanation and be guided by the overall credit history of the borrower.
On the other hand, a person who has previously owned a home and has adequate income to meet the financial requirements of a mortgage may have a payment record which has not demonstrated the desire to pay, for example, consistently late payments.

What if the borrower has had a poor credit history? Does it mean he is automatically eliminated from any type of real estate loan? While it is a big strike against the borrower, it does not mean he'll will never obtain a loan. If he is able to explain the reason for the poor credit and convince the lender that he is now a good risk, the loan will be seriously considered. People get into financial difficulties for reasons beyond their control. Unemployment, illness, and divorce are frequent reasons. If a borrower had a credit problem in the past because of unemployment, it does not mean the borrower lacks the desire to pay. It just means there was a temporary problem.

- ♦ **Bankruptcies** - People who have had bankruptcies are a special problem. They have had "credit failures." It is possible for them to get another loan, but much more difficult, because bankruptcy is usually regarded as an inability to accumulate and manage money. In considering those who have had a bankruptcy, lenders want to know the type of bankruptcy. Was it a liquidation (Chapter 7) or a Chapter 13? Under a Chapter 13, also called the wage-earner's bankruptcy, the individual pays off all creditors in full under a schedule approved by the bankruptcy court. The debtor makes payments to a court-appointed trustee, who in turn, makes the payments to the creditors over a two- to three-year period. It is obvious that lenders look more favorably at someone who opted for a Chapter 13 bankruptcy..

Lenders want a complete explanation why the bankruptcy took place. Was it due to circumstances beyond the borrower's control, or due to poor financial management? The reason makes a big difference in the lender's decision. Lenders also insist that time has elapsed since the discharge of the bankruptcy. Most lenders require a two- to three-year waiting period. Under a Chapter 13 bankruptcy, lenders consider the borrower after all creditors have been paid. In some cases, they may even consider the loan if the borrower has completed most of the payments. Another requirement is that borrowers have established good credit since the bankruptcy. Lenders want evidence that the buyer is paying existing debts on a timely basis. Under a Chapter 13 bankruptcy, payments to the trustee would serve as a credit reference.

"OTHER MOTIVATIONS AND EMOTION NEEDS"

When examining a borrower's desire to pay, we must also consider the borrower's motivation and their emotion needs on the loans. Sometimes a strong desire on the part of the borrower to make the payments is one of the most important reasons for approving a loan. Among the things a lender considers when trying to determine motivation are:

- ♦ **Desire for homeownership** -During the initial qualification of your buyer, you need to establish the underlying desire for homeownership. There can be many reasons, including:
 - **Nesting** - This is important to young people who either have or are expecting a child.
 - **Investment or Personal Use** - Is the borrower buying the home for *personal* use, or is the purchase an *investment* that is going to be rented? If the purchase is for personal use, the borrower is more likely to keep up the payments. If the purchase is an investment, the borrower may not have the same motivation.
 - **Economic** - To beat inflation or to use the home as a tax shelter.
 - **Retirement** - An older couple who has owned a large home is now looking for housing that meets the needs of an older couple and can serve as a home for their later years.
- ♦ **Borrower's Assets** - When analyzing a borrower's capacity to pay, it should be apparent why lenders want to know how much money the borrower earns and the stability of those earnings. What is not so apparent is why lenders analyze borrower assets: because they want to be sure the borrower has enough cash for the down payment and closing costs. If borrowers can't show enough cash, the assumption is that the funds will be sought elsewhere and

another debt incurred. This, in turn, can reduce the borrower's ability to make mortgage payments.

Young couples often receive money for a down payment from their parents. If it is a gift and not a loan, no lender objects to it. However, most lenders insist that the gift be verified, usually in writing. This is called a "**gift letter**." Gift giving is restricted in certain programs. Under certain loans, including FHA, homebuyers have to document the gift with cancelled check or other evidence showing that the funds came from the parents' account.

The amount and type of assets a borrower has will influence lenders. If he has substantial liquid assets, lenders feel more secure. Borrowers with good bank accounts or other assets also demonstrate that they live within their means, are conservative in financial affairs, and have the *ability to accumulate and manage money*.

- ♦ **Down Payment** - The amount of down payment heavily influences the borrower's desire to keep up loan payments. If you purchase a house for \$100,000 and made a down payment of \$50,000, you would do everything possible to maintain the payments. If it became impossible to keep up the payments, you would sell the house. One way or another, you would not let the lender take your house by foreclosure. You would protect your \$50,000 investment. On the other hand, if you had purchased the same property with little or no down payment, you may not be as motivated to maintain the payments. If you run into financial problems, it might be easy to accept letting the lender take back the property. If you have no money invested in the property, you have nothing to lose except your credit rating. You could easily decide to let the lender foreclose.

Lenders recognize the importance of the size of the down payment. As the down payment increases, the lender's risk decreases. The size of the down payment is one of the most important factors in determining whether a loan will be approved.

☞ No matter what the emotional need of the prospective buyers, many lenders look to see the underlying desire for homeownership.

LIABILITIES

In addition to income and emotional reason for buying, the next is their debts and/or financial obligations. These debts and/or obligations can be divided into two types: long-term and short-term. Most investors are interested in only the long-term debts with a major effect on a borrower's ability to repay the mortgage. Guidelines used by FHA, Fannie Mae, and Freddie Mac to determine what constitutes a long-term debt will be discussed later.

What are some of the typical debts that prospective homebuyers may have?

- ♦ **Installment Debts** - This type of debt can be payments made on a regular basis to department stores for a revolving charge account or a contract on appliances. It can also be payments made on bank credit where there is a continuous balance. Underwriting has become more stringent in this area and credit card payments will be attributed to the borrower even if there is a zero balance. This may be a nominal assessment of \$10.00 per month per card, but it represents a potential to expand credit outstanding on the part of the borrower. Most families have a car loan or a bank loan that may be counted as a long-term debt.
- ♦ **Loans Other Than Bank Loans** - Many people are members of credit unions and have loans from the credit union that are used for many purposes, including the purchase of stocks and sometimes recreational lots or acreage.
- ♦ **Co Maker Or Endorser Of A Note** - In some cases a member of a family will have been a cosigner on a note or loan for one of the older children or a friend. This will have to be shown on the loan application of the homebuyer.
- ♦ **Child Support Or Alimony** - This type of court enforced obligation of the prospective homebuyer can be the major payment made apart from the mortgage payment. As divorce laws change throughout the United States, in addition to the father being required to make child support payments, some mothers have been ordered to make child support payments to the father if he has been given custody of the children.

DEBT ANALYSIS

In the past, many real estate professionals have used the formula for the amount of loan a person or family can qualify for as approximately 2.5 times the annual salary. No reference was made to the amount of debts that the person or family had, or how much of the income was used to satisfy those obligations. Today, there are no hard and fast rules used by all conventional lenders to establish ratios of housing cost to income and long-term debts to income. The ratios used by VA and FHA are used by all lenders for underwriting loans either insured by FHA or guaranteed by VA. If your buyer is going to apply for either a loan insured by FHA or guaranteed by VA, you should be able to show your buyer the method for income and debt analysis and be able to determine the approximate loan amount he or she will be able to repay, based on the information he or she supplied.

INCOME RATIOS

Lenders use the monthly payment on a property in determining a borrower's qualifications. The payment includes principal, interest, property taxes, and insurance—commonly referred to as *PITI*. Even if the borrowers are paying their own taxes and insurance, the lender adds them all together in qualifying the borrowers. For FHA, Mutual Mortgage Insurance (MMI) is also included. For condos and PUDs, lenders also include homeowner dues or assessments (PITI).

Lenders use ratios in qualifying a borrower's income. For example, the lender may say the *monthly payment* cannot exceed 25 percent of the borrower's gross income.

Income ratios used by lenders vary. In many areas of California, borrowers pay about one-third or more of their income for housing. The ratios a lender uses are a matter of policy, though most conventional lenders are strongly influenced by the standards set by Fannie Mae and Freddie Mac. They want to make loans that are saleable in the secondary market. Since these two agencies are the main secondary market sources, many lenders use their income ratio standards.

The current published qualifying income ratio used by the agencies is 28 percent. Therefore, the borrowers' monthly payments should not exceed 28 percent of their gross income. Expressing it as a multiplier, we would say the borrower should earn almost four times the monthly payment. Ratios used by the agencies may change at any time because, as the cost of housing increases, borrowers allocate more of their income to housing.

FRONT-END RATIO

The ratio of mortgage payment with gross income is frequently referred to as the **TOP RATIO** or **FRONT-END** or **FRONT-DOOR RATIO**.

$$\text{Front-End Ratio} = \text{Monthly Mortgage Payment} / \text{Monthly Gross Income}$$

The qualifying ratio is merely a guide, and many loans are approved with higher ratios when "compensating factors" exist, serving as a buffer in case the borrowers face difficulty in meeting payments. Some examples of when a lender would feel justified in approving a higher loan ratio:

- ♦ Borrowers have a substantial cushion. If the net worth is liquid, it can be used to make the mortgage payments if necessary.
- ♦ Borrower has a creditworthy co-borrower with additional income.
- ♦ Borrowers have excellent potential for higher earnings due to education or training, and current income is stable.

- ♦ Borrowers are making a large down payment.
- ♦ Borrowers have been making mortgage or rent payments at about the same level as the new loan.

Example:

Borrower Jeffrey's monthly PITI payment is \$1500, and his monthly income is \$7,000.

Mortgage payment / Gross income = \$1,500 / \$7,000 = 21.43%

☞ Lenders prefer a front-end ratio of 28% or less for most loans, and 31% or less for Federal Housing Administration (FHA) loans.

Jeffrey would qualify based on current income guides.

Buy-down loans, graduated-payment mortgages, and adjustable rate loans require special handling. With these, the initial payment is lower, and then increases. The problem is, what payment do you use in qualifying the borrower? Lenders' choices vary. Some use the initial payment, provided there is a reasonable expectation that the borrower's income will increase to cover the yearly increases in payments. By using the initial payment, borrowers are able to qualify for a larger loan. This is one of the major advantages of buy-downs, graduated-payment mortgages, and adjustable rate loans. In some cases, lenders have tightened their standards and qualify borrowers based only on the "fully indexed" payments -- the index plus the margin at time of qualifying.

BACK-END RATIO

So far, we have discussed only a borrower's gross income. Lenders must also take into account the borrower's debts. Lenders break debts into two categories -- short term and long term. The short-term debts are generally ignored, and only long-term debts are considered in qualifying a borrower. How are long-term debts defined?

According to the ratios in effect in 2013, the maximum amount of an applicant's income that could be spent for the payment of long-term debts is 36 percent. According to Fannie Mae/Freddie Mac, a long-term debt is any debt that extends beyond 10 months and must include the amount of the house payment as outlined above. The long-term debt must include any child support or alimony payments.

Conventional lenders follow the standards of Fannie Mae, Freddie Mac, FHA, and PMI companies, which define a long-term debt as a debt that will take *10 months* or longer to pay off. Alimony and child support payments are also considered long-term debts if they will continue for more than 10 months. Other non-housing consumer loans such as auto,

furniture and credit card loans are generally counts towards long-term debts.

Once long-term debts have been determined, the lender adds the total to the monthly payment. The two, added together, are called "**total monthly expenses.**"

$$\text{Total monthly debt expense} = \text{Long Term Debts} + \text{Monthly Mortgage Expense}$$

The total monthly expenses are divided by the borrower's gross income, coming up with another ratio, called the bottom ratio or **BACK-END RATIO** or **back-door ratio**.

$$\text{Back-End Ratio} = (\text{Total Monthly Debt Expense} / \text{Gross Monthly Income})$$

☞ *The lender use the back-end ratio to see the borrower's financial picture of total obligations.*

☞ *Conventional lenders again use FNMA and Freddie Mac current standards, which state that this back-end ratio **should not exceed 38%**, including PMI.*

Example:

Borrower Jeffrey has three loans. He has a car loan of monthly payment of \$500 that takes three years to pay off, a school loan of monthly payment of \$300 that takes four years to pay off. Therefore, they are long-term debts. He has a personal loan with a friend with a monthly payment of \$150.00 that takes six months to pay off.

Therefore, Jeffrey's long-term debts total \$950 per month, which, added to the mortgage payment of \$1,500, gives us a total monthly expense of \$2450.

$$\text{Total monthly expense} / \text{Gross income} = \$2450 / \$7000 = 35\%$$

On the basis of this back-end ratio, Jeffrey also qualifies, since his total monthly expenses are less than 38 percent. Borrowers must qualify on both tests. Some qualify on the first test but not on the second test because they have excessive debts. The second ratio is almost always the more important of the two.

EASY QUALIFYING - LIMITED DOCUMENTS

With 25 percent or larger down payments many lenders offer "limited document" or "easy qualifying" loans, requiring no income or deposit verifications, no IRS W-2s, and no employment verification.

QUALIFYING UNDER CONVENTIONAL GUIDELINES

Many conventional lenders have adopted the income-to-payment and long-term-debt-to-income ratios of Fannie Mae/Freddie Mac for the underwriting of their loans. These are:

The mortgage loan broker should assume that most lenders will use FNMA or FHLMC guidelines as the industry standard, unless given different information when asking about the original setup arrangement. Pre-qualification of the borrower must include not only the principal and interest, but also the taxes and insurance, even though the borrower may choose to make his or her own payments for these items rather than have the lender impound the account. The down-payment requirement for conventional loans usually exceeds the amount required for either FHA or DVA loans. The benefit for conventional financing is that many more lenders are available to fund these loans, and the loan amount is greater, which allows the borrower a wider range of properties to purchase.

The maximum amount a person or family may spend for the monthly payment on housing is **28 percent** of the total gross stable monthly income. The monthly payment includes the following: payments for principal and interest, the amount needed to pay for private mortgage insurance if required, an escrow amount collected monthly to cover the taxes and insurance on the property, and sufficient funds to pay any other fees that may affect title to the property. Such additional fees could be homeowners association fees or special assessments levied by a taxing authority for streets or curbs and gutters.

Many lenders will allow a higher monthly payment ratio if it can be shown that the borrower and the co-borrower can devote more income to the cost of housing or if the property is constructed to be energy efficient. According to Freddie Mac's, *Sellers and Servicers Guide*, Section 2308, higher monthly payment ratios may be appropriate if the following conditions are met:

- (i) energy efficient property which reduces energy costs;
- (ii) demonstrated ability of Borrower to devote a greater portion of income to basic needs, such as housing;
- (iii) demonstrated ability of Borrower to maintain a good credit history, accumulate savings and maintain a debt-free position;
- (iv) a larger down payment on the purchase of the property;

- (v) Borrower's potential for increased earnings based on education, job training or time employed or practiced in his/her profession: and
- (vi) Borrower's net worth being substantial enough to evidence ability to repay the mortgage regardless of income. When the loan-to-value ratio exceeds 80%, debt service qualification ratios may be subjected to stricter underwriting standards.

Figure 13-1: Conventional Qualifying Ratios

	<i>Ratios should not exceed:</i>
95% LTV	26/33
90% LTV	28/36
80% LTV	32/38
Adjustable	26/36

Figure 13-2: Conventional Loans: Calculating the maximum loan amount from gross income

Example:

Gross income	3500	
Back-end ratio	x 36%	
Total available for debt service	\$1260	
Monthly installment debts	- 200	
	\$1060	
Taxes and insurance/HOA	- 150	
Total principal and interest	\$910	
Payment factor for 8.0% interest rate for 30 years	Divide by / 7.337646	
Loan amount	\$124,017	(round down to \$124,000)

Note: To calculate the sales price the borrower may borrow, divide the loan amount by the LTV.

Maximum purchase price: $\$124,017 / 0.90 = \$137,797.00$

Note: Conventional loans qualify with a front-end ratio, too. Be sure to take this into account during your final calculations.

Example:

Total allowable housing expenses	\$910
Divide by gross income	Divide by 3500
Front end ratio	26%

This 26 percent is within the guideline for a FNMA 90 percent LTV.

QUALIFYING UNDER GOVERNMENT-BACKED LOANS GUIDELINES

FHA QUALIFYING RATIOS AND CALCULATING MAXIMUM LOAN AMOUNT FROM GROSS INCOME

The FHA uses the same qualifying procedure as conventional lenders.

☞ FHA states that the front-end ratio should not exceed 31 percent, while the back-end ratio-the more important of the two qualifying tests-should not exceed 41 percent, including MMI.

The FHA ratios are higher due to inclusion of MMI in the monthly payments.

The discussion here is limited to the loan broker Federal Housing Administration (FHA) forms needed for calculating the maximum loan amount and the borrower's loan qualification information.

The first step for the mortgage loan broker is to calculate the maximum loan amount from the gross income, with an example shown in Figure 13-3. When the form is followed step by step the result will be the maximum loan amount as set by FHA, which the lender will use as the basic loan guideline. The borrower(s) furnish the mortgage loan broker with proof of their total verifiable income from all sources and the total monthly expenses that would continue six months after the loan would close. The broker then includes the new loan debt into the formula to derive the maximum monthly payment which is used to calculate the maximum loan amount at the current prevailing interest rate.

The qualifying ratios must also be determined. According to FHA guidelines, the front-end ratio must not exceed a maximum of **29 percent**, unless the borrower has compensating factors, such as cash reserves or large equity in other assets. The total housing payment is divided by the total gross income. The back-end ratio consists of dividing the total housing payment plus any long-term debts and is divided by the total gross income. This cannot exceed **41 percent**. Lenders rarely vary from the FHA ratio guidelines. These items are shown in figure below.

Once the maximum loan amount has been derived, the cash down payment is added to calculate the total maximum sales price. The amount

of cash down payment is in excess of the cash needed for any closing costs that must be paid prior to the close of escrow.

Figure 13-3: FHA Loans: Calculating the maximum loan amount from gross income

Example:

<i>Gross income</i>	<i>3500</i>
<i>Back-end ratio</i>	<i>x 41%</i>
<i>Total available for debt service</i>	<i>\$1435</i>
<i>Monthly installment debts</i>	<i>- 200</i>
	<i>\$1235</i>
<i>Taxes and insurance/HOA</i>	<i>-150</i>
<i>Total principal and interest</i>	<i>\$1085</i>
<i>Payment factor for 8.0% interest rate for 30 years (see figure 13-4)</i>	<i>Divide by / 7.337646</i>
<i>Loan amount</i>	<i>\$147,867 (round down to \$147,850)</i>

Remember: FHA also has a front-end ratio of 29 percent. After establishing your estimated loan amount, check your front-end ratio for compliance with FHA guidelines.

Example

Using figures from above:

\$1085 Total allowable housing expense
Divide by \$3500 Gross income = 31% Front-end ratio

This 31% exceeds our 29% guideline.
With "compensating factors" this may still be acceptable to FHA.

Figure 13-4: Principal & Interest factors, 15 and 30 years

Interest Rate	15-year P&I factor	30-year P&I factor
4.000	7.396879	4.774153
4.125	7.459676	4.846497
4.250	7.522784	4.919399
4.375	7.586204	4.992853
4.500	7.649933	5.066853
4.625	7.713972	5.141395
4.750	7.778320	5.216474
4.875	7.842974	5.292082
5.000	7.907937	5.368216
5.125	7.973204	5.444870

REAL ESTATE FINANCE

5.250	8.038777	5.444870
5.500	8.170835	5.677890
5.750	8.104655	5.599713
5.625	8.237317	5.756564
5.750	8.304101	5.835729
5.875	8.371185	5.915378
6.000	8.438568	5.995505
6.125	8.506250	6.076105
6.250	8.574229	6.157172
6.375	8.642504	6.238699
6.500	8.711074	6.320680
6.625	8.779938	6.403110
6.750	8.849095	6.485981
6.875	8.918543	6.569288
7.000	8.988283	6.653025
7.125	9.058312	6.737185
7.250	9.128629	6.821763
7.375	9.199233	6.906751
7.500	9.270124	6.992145
7.625	9.341299	7.077937
7.750	9.412758	7.164122
7.875	9A84499	7.250694
8.000	9.556521	7.337646
8.125	9.628823	7.424972
8.250	9.701404	7.512666
8.375	9.774262	7.600722
8.500	9.847396	7.689135
8.625	9.920804	7.777897
8.750	9.994487	7.867004
8.875	10.068441	7.956449
9.000	10.142666	8.046226
9.125	10.217160	8.136330
9.250	10.291923	8.226754
9.275	10.366952	8.317494
9.500	10.442247	8.408542
9.625	10.517805	8.499894
9.750	10.593627	8.591544
9.875	10.669709	8.683486
10.000	10.746051	8.775716
10.125	10.822652	8.868226
10.250	10.899509	8.961013
10.375	10.976622	9.054070
10.500	11.053989	9.147393
10.625	11.131609	9.240976
10.750	11.209480	9.334814
10.875	11.287600	9.428901
11.000	11.365969	9.523234

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11.125	11.444585	9.617806
11.250	11.523446	9.712614
11.375	11.602551	9.807651
11.500	11.681898	9.902914
11.625	11.761486	9.998398
11.750	11.841314	10.094097
11.875	11.921379	10.190008
12.000	12.001681	10.286126
12.125	12.082217	10.382446
12.250	12.162987	10.478964
12.375	12.243989	10.575676
12.500	12.325221	10.672578
12.675	12.406682	10.769664
12.750	12.488370	10.866932
12.875	12.570284	10.964377

DEPARTMENT OF VETERANS AFFAIRS (DVA)

The income ratio is determined by taking the monthly housing expenses--principal, interest, property taxes, insurance, and long-term debts--and dividing this by net take-home pay. If this ratio is 41 percent or less, the borrowers qualify. If the ratio is above 41 percent, then the DVA underwriter must look at other things such as an above-average income under the cash flow approach, a high net worth, or a large down payment.

☞ ***DVA allows back-end ratio 41 percent ratios because it includes items other than those used by conventional lenders.***

DVA administrators stress that DVA underwriting standards are guidelines and that they are willing to review individual veteran borrowers who do not automatically qualify, similar to the **compensating factors** considered by FHA. Examples of compensating factors include larger than normal down payment, insignificant use of credit cards, no vehicle payments, substantial net worth, and stable work experience and history. DVA uses the tightest qualifying standards in lending due to the lack of initial equity.

CAL-VET

Cal-Vet uses the following qualifying procedure: From gross income, subtract federal and state income taxes and Social Security to arrive at **adjusted gross income**. Housing expense is arrived at by adding principal, interest, taxes, property and disability insurance, maintenance, and utilities. Next long-term debts, which are any debts that will take longer than one year to pay off, are totaled and subtracted. The **remaining income** is then divided by adjusted gross income to

determine the relationship between that and the amount of money left over. This residual should be at least 50 percent of adjusted gross, though under some circumstances it can be less. This is merely a guide, since Cal-Vet looks closely at the balance of funds left over to determine if they are sufficient to support the family.

FNMA AND FHLMC

How does the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) influence the qualification process? First, they affect the purchasing of qualifying loans. While borrowers do not deal directly with agency, their policies vitally affect the process of qualifying loan applicants. This is due to the secondary markets in which these agencies operate. As discussed in earlier chapter, conventional lenders sell loans in the secondary market, where Fannie Mae and Freddie Mac are by far the biggest buyers.

Second, they foster uniformity. Loans sold to either FNMA or FHLMC must comply with the qualifying ratios of the purchasing agency. Consequently there is greater standardization and uniformity in qualifying borrowers if lenders expect to sell any of their loans to either of the "big players." Any conventional loan sold to these agencies, for example, cannot exceed \$300,700 for a one-unit dwelling, fixed-rate loan, so lenders will limit their loans secured by houses to \$300,700. Of course, this figure is subject to periodic changes, usually upward as house prices increase.

CREDIT CHECK

In addition to the verification of the borrower's income, employment, assets, and liabilities, lenders examine the borrower's credit history.. As with employment and income the lender will check the credit history of the borrower and/or co-borrower for a minimum of two years.

As with many other aspects of the real estate transaction, the federal Fair Credit Reporting Act of 1971 affects the investigation of a borrower's credit. Usually, the credit history of a borrower is reported to the lender or originator by the use of a Standard Factual Data Credit Report.

The act guarantees consumer rights relating to credit information about prospective borrowers' rights to information about their own credit. Three main credit bureaus are used, although several smaller agencies exist. To run a credit report it is necessary to have the written authorization of each person.

The nation's largest credit bureaus operate services that sell credit information to authorized parties. Direct marketers who pitch credit card offers, catalog sales firms, and others may purchase the list of names and

addresses of consumers contained in the credit report database of a credit bureau. They do not, however, sell credit reports without explicit authorization from the actual consumer.

To obtain an actual credit report and meet the guidelines of the laws that pertain to credit, the mortgage broker must have written authorization from the person. One spouse cannot sign to authorize a credit report on the other spouse, nor can a friend or relative.. The only exceptions are the legal documents that the courts have established when one party can act for another, such as a power of attorney or guardianship documents.

The mortgage loan broker must have an original signature in the file that authorizes the broker to run a credit report. The signed credit authorization should specify release of a copy of the authorization to the subsequent, actual lender, who will run the backup credit check. Some credit forms authorize more than just the credit check. They might include authorization for employment verification, bank account verification, and other items that need the signature of the borrower.

Credit report bureaus charge fees for obtaining a record of their information. The price for one individual or for a couple will vary between agencies. If a joint report is sought, the information needed to run the report must be obtained from both people. Agencies have different types of report information, such as personal credit, business credit, public record, and inquiries from other parties.

The primary credit agencies that perform credit reporting bureau activities are listed below. Should it be necessary to deny credit, consumers are entitled to a free copy of their credit report if they write to the credit reporting bureau within thirty (30) days from the date of the denial.

- Experien (formerly known as TRW)
P.O. Box 949
Allen, TX 75013-0949
(800) 682-7654
- Trans Union Credit Information Co.
P.O. Box 390
Springfield, PA 19064
(800) 851-2674
- Equifax
P.O. Box 105813
Atlanta, GA 30348
(800) 685-1111

It is advisable for consumers to have a credit report run annually to check the records for accuracy. Consumers with extremely common names are advised to run their credit report more often, at least twice a year. With

modern technology; consumers can request a credit report by telephone by giving their name and address. They will receive a form by mail to sign, complete, and return. Consumers will receive a copy of their credit report and a detailed explanation of how to read the report information.

To dispute inaccurate credit information, the consumer can write a letter of explanation to keep on file with the credit bureau. The explanation can be up to 50 words and becomes part of the printed credit report. Should the report show information that is not the consumer's, the written explanation would so state. The consumer requires documentation to explain certain items. Consumers should keep at least three years of canceled checks, along with receipts and tax returns to substantiate their credit.

To run a credit report, the mortgage broker needs to obtain:

1. Original signed credit authorization, separate form.
2. Original signature on a loan application form (1003).
3. Credit report fee statement, indicating who pays if a loan closes or is denied.

Although the full loan application form includes a great deal of data, not all the information is needed to run a credit check. Lenders require the mortgage broker to use at least two of the major credit bureaus as part of the loan package submitted for approval. The following is the minimum information required to run a credit check:

1. Full name, including first, middle, and last, plus any nicknames or maiden names.
2. Date of birth (DOB).
3. Social Security number (SSN).
4. Current address (for the past two years).
5. Former address (for the preceding five years)

Mortgage loan brokerage firms often subscribe directly to credit bureaus. The clerical staff of the firm inputs the consumer credit information and the report is sent electronically. Anyone who knowingly obtains information from a credit bureau under false pretenses may be fined up to \$5000 or imprisoned for up to one year, or both. The same law applies to unauthorized disclosures made by officers or employees of a credit bureau or of a mortgage loan company.

FICO CREDIT SCORING

A computerized credit scoring is an attempt to qualify a potential borrower with a single number. The intent is to aid lenders in determining the likelihood of repayment of a loan.

Scoring has been used in other types of consumer lending for more than 40 years but recently has become widely used by the real estate lending community. A repository credit risk score is a specific type of credit score that evaluates the information in a consumer's file at that credit repository.

Fair, Issac & Co. named their credit score after their firm name, and FICO has become the current industry standard. Another firm, Credit Reports, Inc. (CRI) of Tustin, California, began offering scoring in 1993. Each credit repository has a name for their risk score: Experien uses FICO Score; Equifax uses Beacon, and Transunion uses Emperica.

A FICO score rates creditworthiness based on data in the individual's credit bureau files,. and considers credit card and installment debt experience in giving the rating. One million borrowers nationwide were studied and it was found that borrowers with FICO scores below 600 had a one in nine chance of falling seriously behind or defaulting on a real estate loan. Borrowers with scores above 800 had only a one in 1293 chance of having trouble keeping mortgage loan payments current.

Credit bureau scorings evaluate as past delinquencies or derogatory payment behavior, current level of indebtedness, length of credit history, type of credit, frequency of application for credit, and credit lines opened. The score reflects the relative risk of serious delinquency, default, foreclosure, or bankruptcy associated with the specific borrower.

The higher the FICO score, the lower the risk of default. FNMA found that less than 10 percent of their current borrowers had FICO scores below 620. The small group that fell below 620 accounted for half of all defaults.

What constitutes a problem on a credit report? The following are some that have been adopted by many lenders:

1. No more than one 30- or 60-day late payment for a major installment debt. A major installment debt may be a car payment or any account with a balance in excess of \$5,000.
2. No more than two 30- to 60-day late payments on small accounts. This type of account might be a department store charge.

3. No 30- to 60-day late payments showing on a mortgage payment record, unless extreme extenuating circumstances can be proven by the applicant.
4. Many lenders will not approve a mortgage loan if the credit report shows any bankruptcies or repossessions within the past five years. If either has occurred more than five years ago, many lenders will require that the applicant has re-established a good credit record.
5. All liens, judgments, and accounts that have gone to collection must have been satisfied or paid in full.

If a person has any of these entries in his report, they are said to have derogatory credit information. This does not always mean that the applicant may never get credit, but that he may have to provide a satisfactory written explanation stating reasons for the late or missed payments.

When dealing with a lender, it is not uncommon to find that many will not discuss a credit report with an applicant until the applicant has received a copy, since doing so causes them to be considered a credit reporting agency, and required to meet the the Fair Credit Reporting Act standards.

Some lenders take this a step further and will not discuss a credit report at all. If so, they notify the applicant that they have received the report and there is information in the report requiring clarification, and advise the applicant(s) to contact the credit reporting agency for details. A possible reason for some lenders to adopt this policy is that many of the agreements between the credit reporting agencies and their buyers disallow to discussing the report, or that Section 610 Conditions of Disclosure to Consumers in paragraph (c) states "any consumer reporting agency shall provide trained personnel to explain to the consumer any information furnished to him pursuant to Section 609." Since the lenders are not classified as credit reporting agencies and since they do not normally have trained credit reviewing personnel on their staff, they will refer all questions and explanations to the credit reporting agency that provided the report.

Both FNMA and FHLMC urge lenders to use credit scores in evaluating applicants for loans expected to be sold on the secondary money market.

☞ FNMA warns lenders that borrowers rated below 620 should not get loans with very low down payments.

FHLMC is now rejecting 50 percent more audited loans below the new standards. The new underwriting software systems are automatically

producing FICO scores along with LTV and debt-to-equity ratios. In addition, the credit rating score is nondiscriminatory because it does not consider gender or ethnicity and uses only the FICO score as a rating stick.

One question asked by buyers is: How long does a bad entry stay on my credit report?

According to the Fair Credit Reporting Act, Section 605, certain information may not be included on a credit report for a loan with a principal balance of \$50,000 or less. The time limits are as follows:

1. Cases under Title 11 of the U.S. Code or Bankruptcy Act that occurred more than 10 years prior to the date of the credit report.
2. Suits and judgments may not be included in the report where the date of entry is more than seven years, or sooner if the governing statutes of limitations have expired.
3. Paid tax liens where the date of payment is seven years or more prior to the date of the credit report.
4. Accounts placed for collection or charged to profit and loss more than seven years prior to the date of the credit report.
5. Any record of arrest, indictments, or convictions for a crime which from the date of disposition, release, or parole, happened more than seven years before the date of the credit report.
6. Any other adverse action that has happened more than seven years ago.

In some cases, a local credit bureau will not report any information about arrest, indictment, or conviction for a crime.

It's clear that the credit history is an area that may delay the process of a loan application, particularly if the lender does not discuss any information on a credit report. A possible solution is to have your buyer, prior to completing a loan application, visit the credit reporting agency in your city and request to check the credit information that is on file. The consumer has a right to view the information with certain exceptions, per Section 609, Disclosure to Consumers. Consumers will not normally be given a copy of his or her credit report, but will be supplied with an abstract.

The abstract will have stamped or noted on it in some manner "Not for Credit Granting Purposes." Potential applicants can discover if there is any

inaccurate information on the report, and correct or give an explanation before the lender requests a credit report. They can provide a copy of the to the lender. Lenders will still order a credit report, but if the lender questions any entry on the abstract, he can request clarification at the time of application rather than waiting to receive the credit report, and having the buyer make explanations at the credit reporting agency.

If you are working with a buyer who is moving from another city, you may suggest that they have their credit transferred from the city they are leaving, because:

1. If the credit is not transferred, it is classified as an out-of-town credit report and normally the credit reporting agencies charge more.
2. Time to get a report is usually longer, and could possibly slow down loan approval.

CHAPTER 13 QUIZ

1. The best way to shop for a loan is to:
 - A. Make trial applications to several lenders.
 - B. Ask detailed questions of the lenders.
 - C. Read the lenders' advertisements carefully.
 - D. There is no need to shop, since government regulations effectively make all lenders' terms the same.
2. Income is considered stable by most lenders if:
 - A. It has been earned regularly for two years.
 - B. The applicant has been in the same line of work for several years, even if he or she has been on a new job for one month.
 - C. The type of occupation would normally warrant it.
 - D. All of the above
3. Lenders feel justified in approving a higher loan ratio when compensating factors are present, including:
 - A. Exceptional education and training.
 - B. Large down payment.
 - C. Substantial net worth.
 - D. Any of the above.
4. The ability or capacity to pay is best defined as the:
 - A. Applicant's total assets.
 - B. Borrower's willingness to repay loans.
 - C. Ability to repay debts.
 - D. Current mortgage activity.
5. The process by which a borrower can find out in advance what financing is available is called:
 - A. Shopping the loan.
 - B. Pre-qualifying.
 - C. Truth in lending disclosure.
 - D. A conforming loan.
6. Qualifying standards for borrowers using conventional loans that are to be sold to Fannie Mae/Freddie Mac:
 - A. Differ widely, depending upon the particular lender.
 - B. Are usually the same throughout the range of lenders.

- C. Are set by various government agencies.
 - D. Differ greatly, depending upon whether the lender is state or federally chartered.
7. Qualifying for a conventional loan normally does not permit:
- A. Gift money for the down payment.
 - B. A previous bankruptcy.
 - C. A 100% loan (no down payment).
 - D. All of the above.
8. Maximum allowable ratios of housing expense to income can vary with:
- A. Loan to value ratio.
 - B. Lender.
 - C. Size of down payment.
 - D. All of the above.
9. Each of the following is considered income, except:
- A. Continuing spousal support.
 - B. Gifts from family members.
 - C. Positive cash flow from rentals.
 - D. Self-employment income.
10. In a DVA loan, the maximum loan amount is established by:
- A. The U.S. Dept. of Veterans Affairs
 - B. FNMA and GNMA ceilings.
 - C. The lender's policy.
 - D. Both B and C.

*Chapter 13 Answers: 1-B, 2-D, 3-D, 4-C, 5-B, 6-B, 7-D, 8-D, 9-B,
10-C*

CHAPTER 14: THE LOAN PROCESSING



PREVIEW

This chapter describes how lenders process real estate loans. The discussion covers a loan application and a loan package, approval, the process of closing a loan and the documents that are used, closing costs, loan payments, late charges, prepayment privileges and penalties, and loan assumptions. The chapter also details the basic provisions of laws that affect the processing and closing of loans.

LOAN APPLICATION

All loan processing and underwriting begins with an application. The application may be in several forms. We will review only forms used by the FNMA/FHLMC, FHA, and VA standard application form (shown as Form 14-1.)

The loan application is not an appropriate tool for shopping for a loan. It is for the purpose of applying to a specific lender, for a specific loan, under specific terms, on a specific property, by a prospective borrower who presumably will follow through and borrow if the loan is approved.

After receiving the application, the lender makes a preliminary analysis of the borrower's qualifications. If it appears that the applicant is qualified, the lender orders an appraisal of the property. Though procedures differ, many lenders begin processing applications while awaiting the appraisal report.

If the borrower is not qualified based on a preliminary look at the application, many lenders may not order the approval.

Lenders expect repayment of loans without experiencing collection, servicing, or foreclosure difficulties. Lenders are understandably concerned that they make loans to individuals who will repay in a timely manner. Therefore, employment stability, income probability, history of

debt management and net worth are important considerations for the lender in evaluating ability to meet financial obligations.

Even though applications vary in format and length, they generally ask the same basic questions, including:

1. Employment.
2. Income.
3. Assets.
4. Debts.
5. Credit..

☞ *Many lenders use the FNMA 1003 form even if the loans are not intended to be sold in the secondary market.*

BORROWER'S INFORMATION

Helps a lender evaluate a borrower's ability and willingness to repay the loan.

- ♦ **Employment** - Gross salary, type of employment, and length of time employed are considerations. Two years full-time employment in the same field is generally desirable. However, a college degree with a major in the field of employment will often be accepted in lieu of the two years employment. Self-employed borrowers are usually required to provide two to three years' financial statements as well as income tax returns for lender review.
- ♦ **Other Income** - Many families today rely heavily on secondary income (part-time employment, bonuses, overtime.) If this income is typical for the occupation and stable, the lender will probably look favorably upon it in evaluating the borrower's earning capacity, as many components make up income probability. If a borrower is self-employed, profit and loss statements, balance sheets and copy of borrower's signed federal income tax returns for the two years immediately prior to the loan application are usually requested as verification of income.
- ♦ **Dependents** - Number of dependents being supported by the borrower, and for how long, is a consideration.
- ♦ **Living Expenses** - The lender considers the amount of the applicant's income remaining to pay on the loan, taxes, and insurance, after deducting living expenses. Current mortgage payments or current rent payments are relevant.
- ♦ **Relationship with the Lender** - If a borrower has a previous or existing relationship with the lender, the lender may evaluate that

relationship when considering the borrower's latest application, subject to certain non-discrimination laws.

- ♦ **References and Credit Reports** - The lender will check credit and personal references of the borrower. Telephone checks and the use of credit reporting agencies are common. The borrower should bring any delinquencies to the attention of the lender, and the reason they occurred, rather than letting the lender discover them later.
- ♦ **Property Information** - The property financed is the collateral for the loan. Information is required by the lender to determine its value as security. (See previous chapter, "Qualifying the Property.")
- ♦ **Identification** - Specific location of the property, normally the legal description.
- ♦ **Preliminary Title Information** - Any claims, encumbrances, liens, etc.
- ♦ **Improvements** - Description of land and improvements, including any work done in the past 90 days that might be subject to a mechanic's lien.
- ♦ **Economic Data** - Taxes, zoning, assessments, price and terms, date of construction, and income data if an income property.
- ♦ **Rental Statement** (for income property) - The repayment ability of the property; the property's capacity to generate enough income toward repaying the loan.
- ♦ **All Pertinent Data** - The loan application is designed to show all pertinent data needed by a lender to evaluate borrowers. Perhaps the one most important item the loan officer seeks in the application and loan interview is evidence stability in money management, debt payments, and employment.
- ♦ **Prohibited Discrimination** - It is clear from the previous paragraph that a lender must be very discriminating in approving loans, carefully evaluating financial ability and reliability. The Federal Equal Credit Opportunity Act (ECOA) prohibits discrimination based on age, sex, race, marital status, color, religion, or national origin. Senior citizens, young adults, and single persons must be considered in light of income adequacy, satisfactory net worth, job stability and satisfactory credit rating. Credit guidelines must be applied to each prospective borrower in the same manner.

☞ The more thorough the information provided by the borrower the faster and easier it is for the loan officer to verify and evaluate the loan application.

TAKING THE LOAN APPLICATION

The lender evaluates the initial information obtained on the borrower and the property.

- ♦ **Borrower Interview** - Many lenders regard a personal interview as highly desirable. Reasons for this include *verification* and *clarification*.
 - **Application Accuracy** - The loan officer has the opportunity to verify the accuracy of the information with the applicant and to make a personal judgment of the borrower's character. The loan officer may complete the loan application during the personal interview.
 - **Ability to Repay** - The loan officer can verify this with the borrower. For example, is the borrower's income adequate to make payments? The loan officer may collect such things as IRS W-2 forms for the past two years, IRS 1040s, or recent pay check stubs, and may verify current status of outstanding financial obligations.
 - **Loan Costs** - All costs involved should be discussed and understood by the borrower.
- ♦ **Appraisal Report** - This can be made by an employee of the lender or by an outside appraiser. The current value of the property and the value trend are needed.

COMPLETING THE FNMA UNIFORM RESIDENTIAL LOAN APPLICATION

The first section of the application has to do with the type of mortgage being applied for: conventional, VA, or FHA. The interest rate and the term of the mortgage as well as the monthly payments are calculated, and finally the escrow or impounds are indicated.

In the next section of the application, Subject Property, the property is identified by both a street address and a legal description. Next, the lender will need to know the purpose of the loan, whether it is to purchase, construct, or refinance. If the purpose is either to construct or to refinance, additional information is requested. The final portion of this section asks in whose names the title to the property will be held and in what manner the title will be held: community property, tenancy-in-common, joint tenancy, etc.

You need to tell the prospective homebuyer how the title can be held and help him or her arrive at a decision, or advise them of the lender's requirements as to how the title will be held.

The next sections have to do with the borrower and co-borrower. Normally, a lender will not allow the borrower to provide data for the co-borrower, and vice-versa. Both parties must be present at the time of application. What information is required seems self-explanatory, but there are some important items that should be reviewed. The first is the

applicant's present address. If either the borrower or co-borrower has resided at his or her present address for less than two years, the lender will request the prior address to establish residency for the past two years. If the borrower or co-borrower has rented, the lender needs the name and address of the landlord or rental agent to verify the residency and payment record. If either has owned or was purchasing a home and was making mortgage payments, they have to supply the name and address of the mortgage lender, account number(s) to verify the mortgage and payment records. The borrower and/or the co-borrower also need to furnish the names and addresses of employers for the past two years. These addresses should be accurate, for the lender will wish to verify the employment. If the address is incorrect, it can slow the processing of the application.

The next section of the application is divided into three sections: Gross Monthly Income, Monthly Housing Expenses, and Details of the Purchase. This section is self-explanatory and the information required is not difficult to furnish.

In the next section of the application, the borrower or co-borrower describes other income, if any. Once again, sufficient information must be supplied to allow the lender to verify the income.

In the section "If Employed in the Current Position for Less Than Two Years," the borrower and co-borrower are given additional room to establish a two-year work record. The information must be sufficient to allow the lender to verify the employment.

The final section of the first page is composed of several questions. If any question is answered "yes", the answer must be explained in depth.

The second page of the application is devoted primarily to the financial and credit history of the borrower and co-borrower. The first section is divided into two parts, the first covering the assets and the second covering the liabilities of the borrower or co-borrower. Complete information about any installment debts is once again required. The lender verifying the credit of the borrower or co-borrower will need this information for the credit-checking agency.

At the end of the liability and assets section is the section for the borrower and co-borrower to list all of the real estate they own. They must state whether the property is sold, a sale is pending, or if the property is being held for rental purposes. If the property is sold, the lender will require a copy of a closing statement. If the sale is pending, the lender may request a copy of the earnest money contract and will not close the loan until a copy of the closing statement is furnished, if the sale proceeds are to be used as part of the down payment or for closing costs.

The next major section of the application is for credit references, and listing any loans or charge accounts that have been paid in full to any credit-granting organization.

Immediately below the previous credit section is an agreement the borrower and co-borrower must sign. The borrower and co-borrower at this time must declare their intent either to occupy or not to occupy the property. By signing the statement, the borrower and co-borrower acknowledge that they can be punished by the federal government if they knowingly make any false statement.

Some of the information needed to determine if a lender is discriminating due to color, race, or sex is contained in the section "Information for Government Monitoring Purposes." Because this information is not used in the processing or approval of a loan, the borrower and co-borrower are not required to furnish this information.

Form 14-1: FNMA Uniform Residential Loan Application (4 pages)

REAL ESTATE FINANCE

Uniform Residential Appraisal Report

File #

The purpose of this summary appraisal report is to provide the lender/client with an accurate, and adequately supported, opinion of the market value of the subject property.

Property Address	City	State	Zip Code																																																																								
Borrower	Owner of Public Record	County																																																																									
Legal Description																																																																											
Assessor's Parcel #	Tax Year	R.E. Taxes \$																																																																									
Neighborhood Name	Map Reference	Census Tract																																																																									
Occupant ☐ Owner ☐ Tenant ☐ Vacant	Special Assessments \$	☐ PUD	HOA \$ ☐ per year ☐ per month																																																																								
Property Rights Appraised ☐ Fee Simple ☐ Leasehold ☐ Other (describe)																																																																											
Assignment Type ☐ Purchase Transaction ☐ Refinance Transaction ☐ Other (describe)																																																																											
Lender/Client	Address																																																																										
Is the subject property currently offered for sale or has it been offered for sale in the twelve months prior to the effective date of this appraisal? ☐ Yes ☐ No																																																																											
Report data source(s) used, offering price(s), and date(s).																																																																											
I ☐ did ☐ did not analyze the contract for sale for the subject purchase transaction. Explain the results of the analysis of the contract for sale or why the analysis was not performed.																																																																											
Contract Price \$ Date of Contract Is the property seller the owner of public record? ☐ Yes ☐ No Data Source(s)																																																																											
Is there any financial assistance (loan charges, sale concessions, gift or downpayment assistance, etc.) to be paid by any party on behalf of the borrower? ☐ Yes ☐ No																																																																											
If Yes, report the total dollar amount and describe the items to be paid.																																																																											
Note: Race and the racial composition of the neighborhood are not appraisal factors. <table border="1"> <thead> <tr> <th>Neighborhood Characteristics</th> <th>One-Unit Housing Trends</th> <th>One-Unit Housing</th> <th>Present Land Use %</th> </tr> </thead> <tbody> <tr> <td>Location ☐ Urban ☐ Suburban ☐ Rural</td> <td>Property Values ☐ Increasing ☐ Stable ☐ Declining</td> <td>PRICE</td> <td>One-Unit %</td> </tr> <tr> <td>Built-Up ☐ Over 75% ☐ 25-75% ☐ Under 25%</td> <td>Demand/Supply ☐ Shortage ☐ In Balance ☐ Over Supply</td> <td>AGE</td> <td>2-4 Unit %</td> </tr> <tr> <td>Growth ☐ Rapid ☐ Stable ☐ Slow</td> <td>Marketing Time ☐ Under 3 mths ☐ 3-6 mths ☐ Over 6 mths</td> <td>\$ (000)</td> <td>Multi-Family %</td> </tr> <tr> <td>Neighborhood Boundaries</td> <td></td> <td>Low</td> <td>Commercial %</td> </tr> <tr> <td></td> <td></td> <td>High</td> <td>Other %</td> </tr> <tr> <td></td> <td></td> <td>Pred.</td> <td></td> </tr> </tbody> </table>				Neighborhood Characteristics	One-Unit Housing Trends	One-Unit Housing	Present Land Use %	Location ☐ Urban ☐ Suburban ☐ Rural	Property Values ☐ Increasing ☐ Stable ☐ Declining	PRICE	One-Unit %	Built-Up ☐ Over 75% ☐ 25-75% ☐ Under 25%	Demand/Supply ☐ Shortage ☐ In Balance ☐ Over Supply	AGE	2-4 Unit %	Growth ☐ Rapid ☐ Stable ☐ Slow	Marketing Time ☐ Under 3 mths ☐ 3-6 mths ☐ Over 6 mths	\$ (000)	Multi-Family %	Neighborhood Boundaries		Low	Commercial %			High	Other %			Pred.																																													
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Zoning Compliance ☐ Legal ☐ Legal Nonconforming (Grandfathered Use) ☐ No Zoning ☐ Illegal (describe)																																																																											
Is the highest and best use of the subject property as improved (or as proposed per plans and specifications) the present use? ☐ Yes ☐ No If No, describe																																																																											
Utilities	Public	Other (describe)	Off-site Improvements—Type Public Private																																																																								
Electricity ☐	☐	Water ☐	Street ☐																																																																								
Gas ☐	☐	Sanitary Sewer ☐	Alley ☐																																																																								
FEMA Special Flood Hazard Area ☐ Yes ☐ No FEMA Flood Zone FEMA Map # FEMA Map Date																																																																											
Are the utilities and off-site improvements typical for the market area? ☐ Yes ☐ No If No, describe																																																																											
Are there any adverse site conditions or external factors (easements, encroachments, environmental conditions, land uses, etc.)? ☐ Yes ☐ No If Yes, describe																																																																											
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Appliances ☐ Refrigerator ☐ Range/Oven ☐ Dishwasher ☐ Disposal ☐ Microwave ☐ Washer/Dryer ☐ Other (describe)																																																																											
Finished area above grade contains: Rooms Bedrooms Bath(s) Square Feet of Gross Living Area Above Grade																																																																											
Additional features (special energy efficient items, etc.)																																																																											
Describe the condition of the property (including needed repairs, deterioration, renovations, remodeling, etc.).																																																																											
Are there any physical deficiencies or adverse conditions that affect the livability, soundness, or structural integrity of the property? ☐ Yes ☐ No If Yes, describe																																																																											
Does the property generally conform to the neighborhood (functional utility, style, condition, use, construction, etc.)? ☐ Yes ☐ No If No, describe																																																																											

REAL ESTATE FINANCE

Uniform Residential Appraisal Report

File #

There are comparable properties currently offered for sale in the subject neighborhood ranging in price from \$ to \$												
There are comparable sales in the subject neighborhood within the past twelve months ranging in sale price from \$ to \$												
FEATURE		SUBJECT		COMPARABLE SALE # 1			COMPARABLE SALE # 2			COMPARABLE SALE # 3		
Address												
Proximity to Subject												
Sale Price		\$		\$			\$			\$		
Sale Price/Gross Liv. Area		\$ sq. ft.		\$ sq. ft.			\$ sq. ft.			\$ sq. ft.		
Data Source(s)												
Verification Source(s)												
VALUE ADJUSTMENTS		DESCRIPTION		DESCRIPTION		+(-) \$ Adjustment		DESCRIPTION		+(-) \$ Adjustment		
Sale or Financing Concessions												
Date of Sale/Time												
Location												
Leasehold/Fee Simple												
Site												
View												
Design (Style)												
Quality of Construction												
Actual Age												
Condition												
Above Grade		Total Bdrms. Baths		Total Bdrms. Baths				Total Bdrms. Baths		Total Bdrms. Baths		
Room Count												
Gross Living Area		sq. ft.		sq. ft.				sq. ft.		sq. ft.		
Basement & Finished Rooms Below Grade												
Functional Utility												
Heating/Cooling												
Energy Efficient Items												
Garage/Carport												
Porch/Patio/Deck												
Net Adjustment (Total)				+ - \$				+ - \$				
Adjusted Sale Price of Comparables				Net Adj. % Gross Adj. % \$				Net Adj. % Gross Adj. % \$				
☐ did ☐ did not research the sale or transfer history of the subject property and comparable sales. If not, explain												
My research ☐ did ☐ did not reveal any prior sales or transfers of the subject property for the three years prior to the effective date of this appraisal.												
Data source(s)												
My research ☐ did ☐ did not reveal any prior sales or transfers of the comparable sales for the year prior to the date of sale of the comparable sale.												
Data source(s)												
Report the results of the research and analysis of the prior sale or transfer history of the subject property and comparable sales (report additional prior sales on page 3).												
ITEM		SUBJECT		COMPARABLE SALE # 1			COMPARABLE SALE # 2			COMPARABLE SALE # 3		
Date of Prior Sale/Transfer												
Price of Prior Sale/Transfer												
Data Source(s)												
Effective Date of Data Source(s)												
Analysis of prior sale or transfer history of the subject property and comparable sales												
Summary of Sales Comparison Approach												
Indicated Value by Sales Comparison Approach \$												
Indicated Value by: Sales Comparison Approach \$ Cost Approach (if developed) \$ Income Approach (if developed) \$												
This appraisal is made ☐ "as is", ☐ subject to completion per plans and specifications on the basis of a hypothetical condition that the improvements have been completed, ☐ subject to the following repairs or alterations on the basis of a hypothetical condition that the repairs or alterations have been completed, or ☐ subject to the following required inspection based on the extraordinary assumption that the condition or deficiency does not require alteration or repair.												
Based on a complete visual inspection of the interior and exterior areas of the subject property, defined scope of work, statement of assumptions and limiting conditions, and appraiser's certification, my (our) opinion of the market value, as defined, of the real property that is the subject of this report is \$, as of , which is the date of inspection and the effective date of this appraisal.												

REAL ESTATE FINANCE

Uniform Residential Appraisal Report

File #

ADDITIONAL COMMENTS					
	COST APPROACH	COST APPROACH TO VALUE (not required by Fannie Mae)			
		Provide adequate information for the lender/client to replicate the below cost figures and calculations.			
		Support for the opinion of site value (summary of comparable land sales or other methods for estimating site value)			
		COSTS	ESTIMATED ☐ REPRODUCTION OR ☐ REPLACEMENT COST NEW		OPINION OF SITE VALUE = \$
Source of cost data				Dwelling Sq. Ft. @ \$ = \$	
Quality rating from cost service			Effective date of cost data	Sq. Ft. @ \$ = \$	
Comments on Cost Approach (gross living area calculations, depreciation, etc.)					
			Garage/Carport Sq. Ft. @ \$ = \$		
			Total Estimate of Cost-New = \$		
			Less Physical Functional External		
			Depreciation = \$()		
			Depreciated Cost of Improvements = \$		
			"As-is" Value of Site Improvements = \$		
Estimated Remaining Economic Life (HUD and VA only) Years			Indicated Value By Cost Approach = \$		
INCOME			INCOME APPROACH TO VALUE (not required by Fannie Mae)		
			Estimated Monthly Market Rent \$	X Gross Rent Multiplier	= \$ Indicated Value by Income Approach
			Summary of Income Approach (including support for market rent and GRM)		
		PROJECT INFORMATION FOR PUDs (if applicable)			
		Is the developer/builder in control of the Homeowners' Association (HOA)? ☐ Yes ☐ No Unit type(s) ☐ Detached ☐ Attached			
		Provide the following information for PUDs ONLY if the developer/builder is in control of the HOA and the subject property is an attached dwelling unit.			
		Legal name of project			
		Total number of phases	Total number of units	Total number of units sold	
	Total number of units rented	Total number of units for sale	Data source(s)		
INFORMATION	Was the project created by the conversion of an existing building(s) into a PUD? ☐ Yes ☐ No If Yes, date of conversion				
	Does the project contain any multi-dwelling units? ☐ Yes ☐ No Data source(s)				
	Are the units, common elements, and recreation facilities complete? ☐ Yes ☐ No If No, describe the status of completion.				
	Are the common elements leased to or by the Homeowners' Association? ☐ Yes ☐ No If Yes, describe the rental terms and options.				
Describe common elements and recreational facilities					

Uniform Residential Appraisal Report

File #

This report form is designed to report an appraisal of a one-unit property or a one-unit property with an accessory unit; including a unit in a planned unit development (PUD). This report form is not designed to report an appraisal of a manufactured home or a unit in a condominium or cooperative project.

This appraisal report is subject to the following scope of work, intended use, intended user, definition of market value, statement of assumptions and limiting conditions, and certifications. Modifications, additions, or deletions to the intended use, intended user, definition of market value, or assumptions and limiting conditions are not permitted. The appraiser may expand the scope of work to include any additional research or analysis necessary based on the complexity of this appraisal assignment. Modifications or deletions to the certifications are also not permitted. However, additional certifications that do not constitute material alterations to this appraisal report, such as those required by law or those related to the appraiser's continuing education or membership in an appraisal organization, are permitted.

SCOPE OF WORK: The scope of work for this appraisal is defined by the complexity of this appraisal assignment and the reporting requirements of this appraisal report form, including the following definition of market value, statement of assumptions and limiting conditions, and certifications. The appraiser must, at a minimum: (1) perform a complete visual inspection of the interior and exterior areas of the subject property, (2) inspect the neighborhood, (3) inspect each of the comparable sales from at least the street, (4) research, verify, and analyze data from reliable public and/or private sources, and (5) report his or her analysis, opinions, and conclusions in this appraisal report.

INTENDED USE: The intended use of this appraisal report is for the lender/client to evaluate the property that is the subject of this appraisal for a mortgage finance transaction.

INTENDED USER: The intended user of this appraisal report is the lender/client.

DEFINITION OF MARKET VALUE: The most probable price 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, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) buyer and seller are typically motivated; (2) both parties are well informed or well advised, and each acting in what he or she considers his or her own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in terms of cash in U. S. dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions* granted by anyone associated with the sale.

*Adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs which are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party institutional lender that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar for dollar cost of the financing or concession but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the appraiser's judgment.

STATEMENT OF ASSUMPTIONS AND LIMITING CONDITIONS: The appraiser's certification in this report is subject to the following assumptions and limiting conditions:

1. The appraiser will not be responsible for matters of a legal nature that affect either the property being appraised or the title to it, except for information that he or she became aware of during the research involved in performing this appraisal. The appraiser assumes that the title is good and marketable and will not render any opinions about the title.
2. The appraiser has provided a sketch in this appraisal report to show the approximate dimensions of the improvements. The sketch is included only to assist the reader in visualizing the property and understanding the appraiser's determination of its size.
3. The appraiser has examined the available flood maps that are provided by the Federal Emergency Management Agency (or other data sources) and has noted in this appraisal report whether any portion of the subject site is located in an identified Special Flood Hazard Area. Because the appraiser is not a surveyor, he or she makes no guarantees, express or implied, regarding this determination.
4. The appraiser will not give testimony or appear in court because he or she made an appraisal of the property in question, unless specific arrangements to do so have been made beforehand, or as otherwise required by law.
5. The appraiser has noted in this appraisal report any adverse conditions (such as needed repairs, deterioration, the presence of hazardous wastes, toxic substances, etc.) observed during the inspection of the subject property or that he or she became aware of during the research involved in performing this appraisal. Unless otherwise stated in this appraisal report, the appraiser has no knowledge of any hidden or unapparent physical deficiencies or adverse conditions of the property (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) that would make the property less valuable, and has assumed that there are no such conditions and makes no guarantees or warranties, express or implied. The appraiser will not be responsible for any such conditions that do exist or for any engineering or testing that might be required to discover whether such conditions exist. Because the appraiser is not an expert in the field of environmental hazards, this appraisal report must not be considered as an environmental assessment of the property.
6. The appraiser has based his or her appraisal report and valuation conclusion for an appraisal that is subject to satisfactory completion, repairs, or alterations on the assumption that the completion, repairs, or alterations of the subject property will be performed in a professional manner.

Uniform Residential Appraisal Report

File #

APPRAISER'S CERTIFICATION: The Appraiser certifies and agrees that:

1. I have, at a minimum, developed and reported this appraisal in accordance with the scope of work requirements stated in this appraisal report.
2. I performed a complete visual inspection of the interior and exterior areas of the subject property. I reported the condition of the improvements in factual, specific terms. I identified and reported the physical deficiencies that could affect the livability, soundness, or structural integrity of the property.
3. I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.
4. I developed my opinion of the market value of the real property that is the subject of this report based on the sales comparison approach to value. I have adequate comparable market data to develop a reliable sales comparison approach for this appraisal assignment. I further certify that I considered the cost and income approaches to value but did not develop them, unless otherwise indicated in this report.
5. I researched, verified, analyzed, and reported on any current agreement for sale for the subject property, any offering for sale of the subject property in the twelve months prior to the effective date of this appraisal, and the prior sales of the subject property for a minimum of three years prior to the effective date of this appraisal, unless otherwise indicated in this report.
6. I researched, verified, analyzed, and reported on the prior sales of the comparable sales for a minimum of one year prior to the date of sale of the comparable sale, unless otherwise indicated in this report.
7. I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.
8. I have not used comparable sales that were the result of combining a land sale with the contract purchase price of a home that has been built or will be built on the land.
9. I have reported adjustments to the comparable sales that reflect the market's reaction to the differences between the subject property and the comparable sales.
10. I verified, from a disinterested source, all information in this report that was provided by parties who have a financial interest in the sale or financing of the subject property.
11. I have knowledge and experience in appraising this type of property in this market area.
12. I am aware of, and have access to, the necessary and appropriate public and private data sources, such as multiple listing services, tax assessment records, public land records and other such data sources for the area in which the property is located.
13. I obtained the information, estimates, and opinions furnished by other parties and expressed in this appraisal report from reliable sources that I believe to be true and correct.
14. I have taken into consideration the factors that have an impact on value with respect to the subject neighborhood, subject property, and the proximity of the subject property to adverse influences in the development of my opinion of market value. I have noted in this appraisal report any adverse conditions (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) observed during the inspection of the subject property or that I became aware of during the research involved in performing this appraisal. I have considered these adverse conditions in my analysis of the property value, and have reported on the effect of the conditions on the value and marketability of the subject property.
15. I have not knowingly withheld any significant information from this appraisal report and, to the best of my knowledge, all statements and information in this appraisal report are true and correct.
16. I stated in this appraisal report my own personal, unbiased, and professional analysis, opinions, and conclusions, which are subject only to the assumptions and limiting conditions in this appraisal report.
17. I have no present or prospective interest in the property that is the subject of this report, and I have no present or prospective personal interest or bias with respect to the participants in the transaction. I did not base, either partially or completely, my analysis and/or opinion of market value in this appraisal report on the race, color, religion, sex, age, marital status, handicap, familial status, or national origin of either the prospective owners or occupants of the subject property or of the present owners or occupants of the properties in the vicinity of the subject property or on any other basis prohibited by law.
18. My employment and/or compensation for performing this appraisal or any future or anticipated appraisals was not conditioned on any agreement or understanding, written or otherwise, that I would report (or present analysis supporting) a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event (such as approval of a pending mortgage loan application).
19. I personally prepared all conclusions and opinions about the real estate that were set forth in this appraisal report. If I relied on significant real property appraisal assistance from any individual or individuals in the performance of this appraisal or the preparation of this appraisal report, I have named such individual(s) and disclosed the specific tasks performed in this appraisal report. I certify that any individual so named is qualified to perform the tasks. I have not authorized anyone to make a change to any item in this appraisal report; therefore, any change made to this appraisal is unauthorized and I will take no responsibility for it.
20. I identified the lender/client in this appraisal report who is the individual, organization, or agent for the organization that ordered and will receive this appraisal report.

You now have a better understanding of the information required by the lender at the time of the face-to-face interview to gather the data for the loan application. Often a lender will use a copy of the Residential Loan Application even though the applicant is applying for a FHA-insured or VA-guaranteed loan.

INFORMATION FOR LOAN APPLICATION

You now have a better understanding of the information required by the lender at the time of the face-to-face interview to gather the data for the loan application. Often a lender will use a copy of the Residential Loan Application even though the applicant is applying for a FHA-insured or VA-guaranteed loan.

As a real estate professional you should counsel your prospective homebuyer concerning the documentation and information they should bring with them when they make application. If possible, you should accompany your buyers to the application appointment. This is important, for no matter how many times a person has gone through the loan application process, it is still a daunting experience. You will be a familiar face and comfort to them. You can use the following *partial* list of information needed at the time of loan application, and add to it as you become more experienced.

1. A legible copy of the earnest money contract for the transaction, containing the original signatures of the parties to the transaction. The buyer's names on the contract should read in the same manner as they will hold title to the property they are purchasing.
2. If the applicant and/or co-applicant have resided at their address for less than two years, sufficient addresses for the lender to verify residence for a period of two years.
3. If they own their current home and it is mortgaged, the name, address, and zip code of the mortgage company, as well as the loan number and type).
4. If they are renting, the name and address of their landlord.
5. Copies of their last year's W-2s as well as their most current paycheck stub.
6. Social Security numbers are required on any FHA-insured, VA-guaranteed, or a loan to be sold to Fannie Mae. Freddie Mac does not require this information.

REAL ESTATE FINANCE

7. Names and addresses of all financial institutions as well as account numbers for all checking, savings, credit union, certificates of deposit, money market accounts, etc.
8. If a borrower and/or co-borrower are divorced, a copy of the decree.
9. If the borrower and/or co-borrower will use assets to close, copies of the stock certificates, bonds, certificates of deposits, etc.
10. A list of current obligations, including current balances, account numbers, monthly payments, names, addresses and zip codes of lender or store, as well as account number(s) of all credit bank type cards even though there is no balance.
11. If the applicant is self-employed, signed and dated, individual tax returns with all schedules for the prior two years.. Also a year-to-date profit and loss statement; if possible prepared and signed by a CPA as well as the borrower. If the borrower owns 25 percent or more of a business, two years of tax returns on the business with all schedules.
12. If the borrower and/or co-borrower will be using income from rental properties, a copy of their federal income tax return, Schedule E, Supplemental Income Schedule, as evidence of rental income. Many lenders will not count the rent from any property not listed on Schedule E as income unless the borrower provides a copy of a lease. In addition, they must supply the address of the property, name and address of the lender, loan number, approximate loan balance, amount of the total monthly payment, gross rental income, and the resale value of the property. This information will be used to complete a Schedule of Real Estate Owned.
13. Verification of retirement income, including a photocopy of the award letter (with copies of canceled check attached), tax returns, or IRS W-2 forms.
14. Verification of Social Security income, including a copy of the Social Security Administration's award letter or a copy of the borrower's last 12 bank statements to confirm the regular deposit of the payment.
15. Verification of VA benefits. Most VA benefits are acceptable lenders if they are documented by a letter or distribution forms from the DVA and will continue for at least three years.

16. Verification of income from notes receivable, including a copy of the note to establish the amount and length of payments. Payments must continue for at least three years after the date of the mortgage application and must have been received for the last 12 months.
17. If any of the funds used for a portion of the down payment or closing cost and prepaid is a gift, the borrower and/or co-borrower must provide a copy of a gift letter. This letter must be from a family member or an unrelated person who has demonstrated an established personal relationship to the borrower and/or co-borrower, and who does not relate to the mortgage loan transaction.
18. If any or all of the funds for the down payment and closing costs come from the sale of a previous home, many lenders require a copy of the settlement statement showing the Net to Seller and signed by all parties to the transaction. In some cases they will require a copy of the Grant Deed. If the home has not sold, the borrower needs to provide a copy of the earnest money contract on the home and, upon closing, provide the previously mentioned documents.

If a prospective homebuyer is making application for a FHA-insured loan, they are required to provide additional information. The Department of Housing and Urban Development requires that with all applications, the lender must require the applicant to establish picture identity and evidence of Social Security numbers at the time of the face-to-face interview. In addition, the letter requires the borrower to provide a paycheck stub and if there is a verification of deposit, the lender must obtain a copy of a recent bank statement(s). Copies of these documents (driver's license, identification card, Social Security card, pay stubs, etc.) must be included as part of the application package. This is a brief review of the application information that may be required by a lender. Many lenders have prepared application information checklists. You should check with lenders in your area and secure copies of any such checklists.

UNDERWRITING FORMS

What happens after the application is completed? The lender verifies the employment of the borrowers.

As with the application forms, various lenders have forms to verify employment, income, deposits, mortgage loan payments, rental history, and credit. In this discussion we will examine those forms approved or authorized by Fannie Mae/ Freddie Mac, FHA, and DVA.

VERIFICATION OF EMPLOYMENT

Fannie Mae Form 1005, Request for Verification of Employment, is shown in Form 14-3. The form is divided into three sections. The first is to be completed and signed by the lender and applicant at the time of application. Usually the lender will have the applicant sign several of the forms, just in case the original form is lost. The second section of the form is completed by the present employer, affirming that the applicant or co-applicant is still in his employment. You will notice that part II of the form is divided into two parts, employment record and pay data. Line 13 of the employment section covers the existence of overtime and/or bonuses, and, if they are paid, what the likelihood is of their continuance in the future.

Part III of the form, Verification of Previous Employment, is to be filled out by the employer only if the person signing the request is no longer an employee. This form will be forwarded directly to the employer and the employer will return the completed form directly to the lender. Do not ask the lender if you can hand-carry the verification to help speed up approval. The statement at the bottom specifies that the form must be transmitted directly to the lender without passing through the hands of the applicant or any other party.

Form 14-2: Request for Verification of Employment



Request for Verification of Employment

Privacy Act Notice: This information is to be used by the agency collecting it or its assignees in determining whether you qualify as a prospective mortgagor under its program. It will not be disclosed outside the agency except as required and permitted by law. You do not have to provide this information, but if you do not your application for approval as a prospective mortgagor or borrower may be delayed or rejected. The information requested in this form is authorized by Title 38, USC, Chapter 37 (if VA); by 12 USC, Section 1701 et. seq. (if HUD/FHA); by 42 USC, Section 1452b (if HUD/CPD); and Title 42 USC, 1471 et. seq., or 7 USC, 1921 et. seq. (if USDA/FmHA).

Instructions: Lender — Complete items 1 through 7. Have applicant complete item 8. Forward directly to employer named in item 1.
Employer — Please complete either Part II or Part III as applicable. Complete Part IV and return directly to lender named in item 2.
The form is to be transmitted directly to the lender and is not to be transmitted through the applicant or any other party.

Part I — Request

1. To (Name and address of employer)		2. From (Name and address of lender)	
I certify that this verification has been sent directly to the employer and has not passed through the hands of the applicant or any other interested party.			
3. Signature of Lender	4. Title	5. Date	6. Lender's Number (Optional)
7. Name and Address of Applicant (include employee or badge number)		8. Signature of Applicant	

Part II — Verification of Present Employment

9. Applicant's Date of Employment		10. Present Position		11. Probability of Continued Employment																																											
12A. Current Gross Base Pay (Enter Amount and Check Period) ☐ Annual ☐ Hourly ☐ Monthly ☐ Other (Specify) \$ _____ ☐ Weekly				13. For Military Personnel Only Pay Grade _____ Type _____ Monthly Amount _____ Base Pay \$ _____		14. If Overtime or Bonus is Applicable, Is Its Continuance Likely? Overtime ☐ Yes ☐ No Bonus ☐ Yes ☐ No																																									
12B. Gross Earnings <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th>Type</th> <th>Year To Date</th> <th>Past Year</th> <th>Past Year</th> <th>Rations</th> <th>\$</th> </tr> </thead> <tbody> <tr> <td>Base Pay</td> <td>\$ _____</td> <td>\$ _____</td> <td>\$ _____</td> <td>Flight or Hazard</td> <td>\$ _____</td> </tr> <tr> <td>Overtime</td> <td>\$ _____</td> <td>\$ _____</td> <td>\$ _____</td> <td>Clothing</td> <td>\$ _____</td> </tr> <tr> <td>Commissions</td> <td>\$ _____</td> <td>\$ _____</td> <td>\$ _____</td> <td>Quarters</td> <td>\$ _____</td> </tr> <tr> <td>Bonus</td> <td>\$ _____</td> <td>\$ _____</td> <td>\$ _____</td> <td>Pro Pay</td> <td>\$ _____</td> </tr> <tr> <td>Total</td> <td>\$ 0.00</td> <td>\$ 0.00</td> <td>\$ 0.00</td> <td>Overseas or Combat</td> <td>\$ _____</td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td>Variable Housing Allowance</td> <td>\$ _____</td> </tr> </tbody> </table>				Type	Year To Date	Past Year	Past Year	Rations	\$	Base Pay	\$ _____	\$ _____	\$ _____	Flight or Hazard	\$ _____	Overtime	\$ _____	\$ _____	\$ _____	Clothing	\$ _____	Commissions	\$ _____	\$ _____	\$ _____	Quarters	\$ _____	Bonus	\$ _____	\$ _____	\$ _____	Pro Pay	\$ _____	Total	\$ 0.00	\$ 0.00	\$ 0.00	Overseas or Combat	\$ _____					Variable Housing Allowance	\$ _____	15. If paid hourly — average hours per week _____	
Type	Year To Date	Past Year	Past Year	Rations	\$																																										
Base Pay	\$ _____	\$ _____	\$ _____	Flight or Hazard	\$ _____																																										
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Total	\$ 0.00	\$ 0.00	\$ 0.00	Overseas or Combat	\$ _____																																										
				Variable Housing Allowance	\$ _____																																										
16. Date of applicant's next pay increase _____																																															
17. Projected amount of next pay increase _____																																															
18. Date of applicant's last pay increase _____																																															
19. Amount of last pay increase _____																																															
20. Remarks (If employee was off work for any length of time, please indicate time period and reason) _____																																															

Part III — Verification of Previous Employment

21. Date Hired		23. Salary/Wage at Termination Per (Year) (Month) (Week)	
22. Date Terminated		Base _____ Overtime _____ Commissions _____ Bonus _____	
24. Reason for Leaving		25. Position Held	

Part IV — Authorized Signature - Federal statutes provide severe penalties for any fraud, intentional misrepresentation, or criminal connivance or conspiracy purposed to influence the issuance of any guaranty or insurance by the VA Secretary, the U.S.D.A., FmHA/FHA Commissioner, or the HUD/CPD Assistant Secretary.

26. Signature of Employer		27. Title (Please print or type)		28. Date	
29. Print or type name signed in item 26		30. Phone No.			

Fannie Mae
Form 1005 July 96

Instructions

Verification of Employment

The lender uses this form for applications for conventional first or second mortgages to verify the applicant's past and present employment status.

Copies

Original only.

Printing Instructions

This form must be printed on letter size paper, using portrait format.

Instructions

The applicant must sign this form to authorize his or her employer(s) to release the requested information. Separate forms should be sent to each firm that employed the applicant in the past two years. However, rather than having an applicant sign multiple forms, the lender may have the applicant sign a borrower's signature authorization form, which gives the lender blanket authorization to request the information it needs to evaluate the applicant's creditworthiness. When the lender uses this type of blanket authorization, it must attach a copy of the authorization form to each Form 1005 it sends to the applicant's employer(s).

For First Mortgages:

The lender must send the request directly to the employers. We will not permit the borrower to hand-carry the verification form. The lender must receive the completed form back directly from the employers. The completed form should not be passed through the applicant or any other party.

For Second Mortgages:

The borrower may hand-carry the verification to the employer. The employer will then be required to mail this form directly to the lender.

The lender retains the original form in its mortgage file.

VERIFICATION OF DEPOSITS

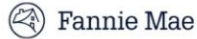
Fannie Mae Form 1006, Request for Verification of Deposit, is shown in Form 14-3. This form is divided into two sections. The first is completed by the lender from information supplied by the applicant and is signed by the applicant, authorizing the financial institution to release the information to the lender. The second section is completed by the financial institution. They are asked to provide information about the deposit accounts and outstanding loans of the applicant.

In the section dealing with deposit accounts, the financial institution is asked to provide the current and average balances for the previous two months. There is reason for such a request. For example, if the present balance in the account is \$10,000 and the average balance for the previous two months has been only \$3,000, the lender will ask the applicant to explain the reason for the increase. The applicant can do this by writing a source of funds letter. (A sample of such a letter will be given later.) In item 1-2a, the institution is asked to provide any additional information that may aid the lender in determining the credit worthiness of the applicant. This should include information about loans that have been paid in full.

The FHA/VA form "Request for Verification of Deposit", requests similar information as the Fannie Mae form, varies in other respects. As with the employment verification form, the lender is required to certify that the verification was sent directly to the bank and that the form did not pass through the hands of the applicant or any other interested party.

Form 14-3: Request for Verification of Deposit

REAL ESTATE FINANCE



Request for Verification of Deposit

Privacy Act Notice: This information is to be used by the agency collecting it or its assignees in determining whether you qualify as a prospective mortgagor under its program. It will not be disclosed outside the agency except as required and permitted by law. You do not have to provide this information, but if you do not your application for approval as a prospective mortgagor or borrower may be delayed or rejected. The information requested in this form is authorized by Title 38, USC, Chapter 37 (If VA); by 12 USC, Section 1701 et seq. (If HUD/FHA); by 42 USC, Section 1452b (if HUD/CPD); and Title 42 USC, 1471 et seq. or 7 USC, 1921 et seq. (If USDA/FmHA).

Instructions: Lender — Complete Items 1 through 8. Have applicant(s) complete Item 9. Forward directly to depository named in Item 1.

Depository — Please complete Items 10 through 18 and return DIRECTLY to lender named in Item 2.

The form is to be transmitted directly to the lender and is not to be transmitted through the applicant(s) or any other party.

Part I — Request

1. To (Name and address of depository)	2. From (Name and address of lender)

I certify that this verification has been sent directly to the bank or depository and has not passed through the hands of the applicant or any other party.

3. Signature of lender	4. Title	5. Date	6. Lender's No. (Optional)

7. Information To Be Verified

Type of Account	Account in Name of	Account Number	Balance
			\$
			\$
			\$

To Depository: I/We have applied for a mortgage loan and stated in my financial statement that the balance on deposit with you is as shown above. You are authorized to verify this information and to supply the lender identified above with the information requested in Items 10 through 13. Your response is solely a matter of courtesy for which no responsibility is attached to your institution or any of your officers.

8. Name and Address of Applicant(s)	9. Signature of Applicant(s)

To Be Completed by Depository

Part II — Verification of Depository

10. Deposit Accounts of Applicant(s)

Type of Account	Account Number	Current Balance	Average Balance For Previous Two Months	Date Opened
		\$	\$	
		\$	\$	
		\$	\$	

11. Loans Outstanding To Applicant(s)

Loan Number	Date of Loan	Original Amount	Current Balance	Installments (Monthly/Quarterly)	Secured By	Number of Late Payments
		\$	\$	\$ per		
		\$	\$	\$ per		
		\$	\$	\$ per		

12. Please include any additional information which may be of assistance in determination of credit worthiness. (Please include information on loans paid-in-full in Item 11 above.)

13. If the name(s) on the account(s) differ from those listed in Item 7, please supply the name(s) on the account(s) as reflected by your records.

Part III — Authorized Signature - Federal statutes provide severe penalties for any fraud, intentional misrepresentation, or criminal connivance or conspiracy purposed to influence the issuance of any guaranty or insurance by the VA Secretary, the U.S.D.A., FmHA/FHA Commissioner, or the HUD/CPD Assistant Secretary.

14. Signature of Depository Representative	15. Title (Please print or type)	16. Date
17. Please print or type name signed in item 14	18. Phone No.	

Fannie Mae
Form 1006 July 96

Instructions

Verification of Deposit

The lender uses this form for applications for conventional first or second mortgages to verify the cash deposits that the applicant listed on the loan application.

Copies

Original only.

Printing Instructions

This form must be printed on letter size paper, using portrait format. When printing this form, you must use the "shrink to fit" option in the Adobe Acrobat print dialogue box.

Instructions

The applicant must sign this form to authorize his or her depository to release the requested information. Separate forms should be sent to each depository named in the loan application. However, rather than having the applicant sign multiple forms, the lender may have the applicant sign a borrower's signature authorization form, which gives the lender blanket authorization to request the information it needs to evaluate the applicant's creditworthiness. When the lender uses this type of blanket authorization, it must attach a copy of the authorization form to each Form 1006 it sends to the depository institutions in which the applicant has accounts.

For First Mortgages

The lender must send the request directly to the depositories. We will not permit the borrower to hand-carry the verification form. The lender must receive the completed form directly from the depositories. The completed form should not be passed through the applicant or any other party.

For Second Mortgages

The borrower may hand-carry the verification to the depositories. The depositories will then be required to mail this form directly to the lender.

The lender retains the original form in its mortgage file.

MORTGAGE VERIFICATION AND/OR RENTAL VERIFICATION

If the applicant has made mortgage payments, the lender will verify the mortgage type, original date and amount of the mortgage, and the payment record of the applicant. If the applicant and/or co-applicant have rented previously, the lender will verify with the landlord, rental agent, or manager of the property the dates of the rental period and the manner of payment.

CREDIT VERIFICATION

Lenders verify an applicant's credit by ordering a credit report from the local credit reporting agency. It provides the applicant's payment history on accounts or loans held by members of the credit reporting agency. By federal law, the applicant and co-applicant are not allowed to view the credit reports furnished to the mortgage lender. If the lender rejects the application, the credit report may not be transferred, and a new report will have to be ordered from the credit reporting agency. If the applicant or co-applicant wishes to inquire into his credit, he must go personally to the credit-reporting agency and request an abstract of his file. The applicant or co-applicant will not be allowed to view the actual file, but will be able to see an abstract of the information in the file. The cost of these reports is usually paid by the applicant or co-applicant.

SOURCE OF FUNDS LETTER

If the balance in a checking or savings account has had a marked increase in the past two months, the lender may request that the applicant or co-applicant furnish information on the source of funds for the increase. If it is the sale of property, the applicant and co-applicant must supply a statement outlining the source and furnish a copy of the settlement statement covering the transfer of the property.

If the additional funds were derived from a gift, the lender may ask the applicant or co-applicant to furnish a statement stating that the money deposited was a gift and the giver does not expect the funds to be repaid.

LOAN PACKAGING/COLLATION

After the loan application is completed and the supporting documents are received, the mortgage lender will gather the information required for underwriting. This is sometimes referred to as loan packaging. The loan package required by lenders will vary, but in the following section we will review some of the standard items that can make up a loan package.

STACKING ORDER

For the underwriter to review the documentation, the file must be placed in a particular order when presented to the lender. Should items be out of place or missing, the file will probably be rejected. Since each type of loan has a separate criteria list, make certain to use the appropriate list.

Current, approved stack order lists are available from the direct lenders. Each lender the mortgage broker works with will have its own particular order. The FNMA and FHLMC office locations to obtain current forms and underwriting books may be obtained from the following:

- ♦ Western Regional Office for Federal National Mortgage Association (Fannie Mae)
135 North Los Robles Avenue, Suite 300 Pasadena, CA 91101-1701 (800) 732-6643, or www.fanniemae.com
- ♦ Western Regional Office for Federal Home Loan Mortgage Corporation (Freddie Mac)
21700 Oxnard, Suite 1900, Woodland Hills, CA 91367 (818) 710-3000, or www.hud.gov

LOAN PACKAGING - CONVENTIONAL

Because many conventional lenders have their own requirements, any of the following items may be included in the conventional loan package:

1. Submission letter. This is a cover letter outlining the items enclosed in the loan package. Usually, the letter will outline the terms and loan-to-value ratio of the mortgage. If the mortgage is one to be purchased by Fannie Mae, they require a form entitled Transmittal Summary, in place of the submission letter.
2. Loan application.
3. Standard factual credit report. This should be current. Many lenders require the report to be less than 90 days old and provided by an approved credit-reporting agency. Many lenders, including Fannie Mae/Freddie Mac, FHA, and VA, have a list of approved credit-reporting agencies. If the credit report is from an agency not approved by the lender, the loan package may be rejected or the lender will order a credit report from the approved agency, which will increase processing or approval time.
4. Verification of deposits.
5. Verification of employment.

6. If the applicant is self-employed, the following information will be supplied in lieu of the verification of employment:
 - A. Business credit report.
 - B. Signed federal income tax returns for the past two years.
 - C. If available, an audited profit-and-loss statement and balance sheets for the past two years.
7. Verification of previous mortgage and payment record or rental verification with payment record.
8. Property appraisal on the lender's approved form:
 - Floor plan and plot sketch.
 - Photographs of the property. (Many lenders require several pictures of the property showing the front, back, and a view looking both ways from the front.)
9. A copy of the earnest money contract.
10. If PMI is required by the lender, a copy of the PMI commitment:
 - Statement of information.
 - Affidavit, stating any plans to sell or rent owned property.
 - Statement of occupancy.
 - Verification of stock and cash value of life insurance, if appropriate.
- ♦ Additional Forms - Transactions involving income properties will also require:
 - Property income and expense report

FHA LOAN PACKAGING

The Department of Housing and Urban Development has established the use of the Uniform Case Binder. Its purpose is to make HUD-FHA closing operations more efficient and assure that a uniform nationwide policy on the order of documents. If the lender is a direct endorsement lender, the order of documents is as follows:

Right Side of Case Binder (top to bottom):

1. Cover letter or transmittal letter (if used), including a mailing label for the DE Underwriting Report (Form HUD 54118) if you want this report to go to an address other than the branch office that originated the loan.
2. Letter of Assignment, where applicable.

REAL ESTATE FINANCE

3. Request for Insurance Endorsement Under the DE Program (available from local field offices.)
4. Current Payment Letter (if necessary.)
5. One-Time MIP Statement of Account (if applicable.)
6. Form HUD-541 13, Underwriter Certification (with signature, identification number and date.)
7. Special certifications or forms, if any, cited in the Underwriter Certification.
8. Copy of note with appropriate riders.
9. Copy of mortgage instrument.
10. HUD-1 Settlement Statement.
11. Form HUD-92900 (copies 1 and 4), Application for Insurance.
12. Form HUD-92900, Mortgage Credit Worksheet (original.)
13. Form HUD-92800.5B, Statement of Appraised Value.
14. Uniform Residential Appraisal Report (original.)
15. Photographs of property and comparable sales data.
16. Form HUD-92800, Application for Property Appraisal and Commitment.

Left Side of Case Binder (top to bottom):

1. Form HUD-92900 (copy 7), Application for Insurance.
2. Form HUD-92900, Mortgage Credit Worksheet (carbon or photocopy.)
3. Uniform Residential Appraisal Report (photocopy.)
4. Mortgagee's Assurance of Completion (Form HUD-92300), where escrow was established for incomplete work.
5. Affirmative Fair Housing Marketing Plan (it applicable.)

6. Copy of Builder Certification (only for "proposed" construction and "existing" construction cases involving new construction and high loan-to-value ratios.)
7. Form HUD-92051, Compliance Inspection Report(s), if applicable, for an "existing" or "proposed" construction case, including photographs of site grading and drainage.
8. Form HUD-92577, Request for Change to Plans and Specifications (if applicable.)
9. Form HUD-92544, Warranty of Substantial Completion with Plans and Specifications. Include One-Year Performance Guaranty from builder on workmanship and materials.
10. Specific Condition(s) clearance documentation (i.e., local health authority approvals, termite inspection report or soil treatment certification, certificate of occupancy, etc.).
11. Ten-Year Warranty Insurance Certification (if applicable.)
12. Credit Report.
13. Verification of Deposit.
14. Copy of bank statement.
15. Verification of Employment.
17. Picture identification of applicant(s).
18. Evidence of Social Security Number(s) of applicant(s) if not on pay stub.
19. Sales contract.
20. Remaining documents-no particular order.

FAILURE TO PREPARE THE CASE BINDER, ASSEMBLE THE DOCUMENTS IN THE PRESCRIBED ORDER OR MARK THE BOXES ON THE FRONT OF THE CASE BINDER TO SHOW THE APPROPRIATE CASE CHARACTERISTICS WILL RESULT IN THE RETURN OF THE CLOSING PACKAGE WITHOUT ENDORSEMENT OF THE MORTGAGE.

DEPARTMENT OF VETERANS AFFAIRS LOAN PACKAGING

A VA loan package may include the following items:

1. Transmittal letter, outlining the loan and the documents that are included in the package (In some areas, the VA guaranty section requires that the documents be in a specific order.)
2. Certificate of Eligibility.
3. Loan application, VA Form 26-1802a.
4. Copy of the earnest money contract.
5. Credit report from an approved credit-reporting agency.
6. Verification of employment.
7. Verification of deposits.
8. A copy of the Certificate of Reasonable Value, VA Form 26-1843
9. Borrower's statement of liability (a statement signed by the veteran stating that if the VA approves the application for home loan guaranty, the veteran is obligated to repay the mortgage.)

Once the loan package is completed, the next step is forwarding the package to the lender for underwriting, or if the originating mortgage company or financial institution has the ability or authority, the loan package will be approved or underwritten by the originator.

COMPUTERIZED LOAN ORIGINATION

With advances in automated lending services by institutional lenders, many real estate brokers and salespersons assist buyers computerized loan origination, (CLO). This does not make you a loan officer, but your California license does permit you to access lenders via a terminal tied into a lender's computer containing that lender's underwriting requirements and other essential data. Agents are able to offer loan comparisons that allow borrowers to see the amount of finance charges and closing costs, and to compare fixed vs. ARM rates and other loan programs and features before making a decision. Agents may collect fees and commissions, as long as these are fully disclosed to clients. Recent court cases have ruled that collecting fees carries with it for a requirement to provide accurate loan information that suits the clients' needs.

The Federal National Mortgage Association, introduced its **Desktop Originator/Desktop Underwriter** for use by loan agents. The **DESKTOP UNDERWRITER (DU)** program allows loan agents with a

laptop computer to take applications at borrowers' homes or businesses and pre-qualify prospects on the spot, obtaining the same information that is obtained for the Uniform Residential Loan Application covered in Chapter 14. There are many others who have followed a similar course, all designed to automate the loan underwriting process in a speedier and more efficient manner.

LOAN UNDERWRITING

After the appraisal is completed, and any other requirements met, it is time for underwriting by the lender.

LOAN UNDERWRITING *is the analysis or evaluation of the risks involved with a loan and matching the risk to the proper return.*

The individual(s) who assembles and analyzes the pertinent data and is authorized to give a company's approval of a specific loan, to a specific borrower, secured by a specific property, is the **underwriter**.

In making an underwriting decision the underwriter must determine the degree of risk to the lender. The degree of risk will influence the loan-to-value ratio, the length of time for repayment, and the interest rate. The underwriter considers following:

- ♦ Borrower's credit and ability to repay the loan.
- ♦ Market value of the property in relation to the loan.
- ♦ Neighborhood and improvements surrounding the subject property.

☞ *The practice of redlining is prohibited.*

This is a form of economic discrimination that operates by not lending in areas which are perceived as "declining."

CHARACTERISTICS OF UNDERWRITING

The purpose of underwriting is to determine if the property is acceptable by lender standards, if the market value supports the loan requested, and if the loan meets the lender's policies. The lender may alter the terms or conditions of the loan to comply with standards and policies. For example, if the appraisal indicates that the roof leaks, the lender may add a condition to the loan approval that the roof be repaired.

The lender also has an interest in the future value of the property, because, in case of foreclosure, there must be sufficient value to cover

the loan. On one- to four-unit properties, estimating future value becomes very subjective and imprecise. Therefore, lenders are concerned about only the early years of the mortgage. If the underwriter is certain, and able to document, that value will likely decrease during the first one to five years, then the terms of the loan may be adjusted, but such adjustments should not exceed the minimum required for the property to be an adequate security. Underwriters are very careful not to violate State of California regulations when making adjustments or in their general underwriting.

CONVENTIONAL LOANS

Conventional loans are approved either by authorized individuals or by a committee. If it is an individual, he has authority to approve loans up to a specified amount. For example, a branch manager of a commercial bank or savings bank may approve home loans up to conforming limits. Any loan exceeding these amounts would be referred to the next level.

FHA AND DVA LOANS

FHA and DVA operate in a similar manner. After the lender has assembled the loan package, it is forwarded to the nearest FHA or DVA office. The packages are given to the mortgage credit sections, where personnel qualify the borrower. Individual loan examiners analyze each loan. If they are unable to make a decision because additional information is needed, they will request it from the lender in writing. If the borrower is qualified, they mail the approval to the lender. If the examiner concludes that the borrower cannot qualify, the loan is given to a supervisor. If the supervisor concurs, the loan is rejected. One person may approve a borrower, but it takes two people to reject the loan.

When borrowers are approved, they should in turn be automatically approved by the appropriate agency. That is why this method of approving loans is referred to as ***DVA automatics***. The major advantage of a DVA automatic is that it reduces the time it takes to get the loan approved involving "in-house underwriting." The loans are approved automatically only if *all* requirements have been met. Through "***direct endorsement***," this automatic approval is also available for FHA loans.

ON-LINE LOAN

The recent surge of home Internet use, coupled with heavy website advertising by lenders and mortgage brokers, many consumers are obtaining real estate loans online. As this trend continues, it should diminish the financial advisory role of real estate sales agents, and reduce the need for face-to-face interaction between borrower and lender.

If a loan is denied

Depending on the circumstances, a borrower whose loan application is denied might consider various alternatives to make the transaction more acceptable to a lender.

- ♦ **Information** - Submit additional qualifying information to the lender, if available.
- ♦ **Re-Application** - Apply to another lender, and/or apply for a different type of loan.
- ♦ **Diminish Debts** - Sell some encumbered assets. Long term debts can hurt a buyer who is trying to qualify for a new loan.
- ♦ **Junior Financing** - Encourage the seller of the property to take back a second trust deed or even a third trust deed at a different interest rate or loan period.
- ♦ **Down payment** - Increase the amount of the down-payment. Price. Encourage the seller of the property to lower the price. Obtain another appraisal, when the first appraisal seems high.
- ♦ **Credit Rating** - Obtain a copy of the credit report received by the lender and correct any inaccuracies which caused the loan to be turned down.
- ♦ **Co-Mortgagor** - Obtain a co-signer to supplement the income qualification.

CLOSING THE LOAN

If a loan is approved, the mechanics of closing the loan are usually coordinated through escrow or either by the lender's in-house escrow department, by an outside escrow company, or by an escrow department of a title insurance company.

A complete escrow includes written instructions by the borrower and lender on done to closing procedures.

ASSEMBLY OF REPORTS

Escrow usually gathers together all required reports and information for review and approval by the parties involved. These typically include:

- ♦ Statement of identity - A title insurance company frequently requires a statement of identity to distinguish a principal from other persons with a similar or identical name.
- ♦ Down-payment, in the form of a cashiers check.
- ♦ Title report, showing condition of title as to conditions, covenants and restrictions (CC&Rs), claims of record, etc.
- ♦ Beneficiary statement or demand for payoff from the seller's lender.
 - ♦ Offset statement from the property owner, when existing loan documents are being sold.

- ♦ Property tax information.
- ♦ Survey, if required, showing exact location and physical condition of the property.
- ♦ Home inspection report, if one has been made.
- ♦ Fire insurance policy.
- ♦ For income property, a statement of all rental payments, tenant deposits, etc., and proration of rents.
- ♦ Structural pest control report and certificate of completion, if appropriate.

Escrow assembles all the necessary documents, properly executed and notarized. Frequently, escrow officer prepares these documents as needed. Escrow also checks to see that all signers of the documents have capacity to sign.

DOCUMENTS PREPARED BY LENDER

After the loan is conditionally approved by the underwriter, the following documents are prepared and require the borrower's signature:

- ♦ Original note and deed of trust
- ♦ Loan escrow instructions
- ♦ Any amendments to loan escrow instructions
- ♦ Certification amendment to loan escrow instructions
- ♦ Truth in lending disclosure form
- ♦ Insurance authorization and requirement chart
- ♦ Loan application for final signature

The promissory note outlines the financial terms of the loan: amount, interest rate, monthly payments, date of first payment, and so on. The promissory note also lists other conditions such as late charges, prepayment privileges and penalties, and acceleration clauses.

A deed of trust is used to secure the repayment of the loan by creating a lien against the property. As explained in an earlier chapter, deeds of trust are used in California instead of mortgages, because of the ease with which a lender can foreclose in case of a borrower's default.

A deed of trust shows only the loan amount, not the interest rate, monthly payments, and so on. The deed of trust says if the debt it secures is not paid, the property may be sold to satisfy the debt. The deed of trust is recorded, while the promissory note is not. To maintain confidentiality between the lender and borrower, the deed of trust shows only the amount of the loan, not the repayment terms. In addition, the deed of trust contains many other detailed agreements between the borrower and lender.

FUNDING THE LOAN

The lender's escrow instructions are sent to the escrow officer, then back to the lender for the lender's funding review. When final approval is given, the check is issued to the escrow officer and the loan is "**funded**."

- ♦ **Recordation** - When all instructions have been compiled, the escrow officer sends documents to be recorded to the county recorder's office, usually through a title company.
- ♦ **Closing Statements** - Statements are rendered to the parties at close of escrow, itemizing the disposition of all funds received and expended by the escrow-holder.

CLOSING COSTS

The escrow officer calculates all charges to all parties and collects all funds necessary. Initial closing statements are prepared, containing estimates where final amounts are not known.

Closing costs are divided into **nonrecurring** those that occur only once, and **recurring**, those that are ongoing.

NONRECURRING CLOSING COSTS

The following costs are **one-time charges** that the buyer-borrower usually pays at close of escrow. The payment of closing costs is negotiable between the buyer and seller.

- ♦ **Loan Origination Fee** - Compensates the lender for some of its expenses in originating the loan, preparing documents, and related work. The fee is usually a percentage of the loan.
- ♦ **Title Policy** - Title policies are issued by title insurance companies, insuring buyers' and lenders' interests in the property against defects of title. There are two basic types of coverage in California: the California land Title Association or CLTA, and the American land Title Association or ALTA. Most lenders require the ALTA policy because it provides additional coverage for the lender. Who pays for the CLTA or standard title policy varies in California, and is always negotiable. For example, it is customary for the seller to pay in Los Angeles and Orange counties; in Contra Costa and San Francisco counties, it is customary for the buyer to pay. There are other counties, such as Merced and San Joaquin, where the cost is split between buyer and seller. In our example, the buyer is paying for the policy. Buyers normally pay for an ALTA policy.
- ♦ **Escrow Fee** - The escrow fee is charged for handling and supervising the escrow. As with title policies, custom also tends to dictate who pays the escrow fee. The buyer is paying the entire fee

in our example, though escrow fees are often split in some fashion between buyer and seller.

- ♦ **Credit Report** - The lender obtains a credit report in qualifying a buyer. The cost of the report is usually charged to the buyer.
- ♦ **Appraisal Fee** - The cost of the appraisal varies with the type of loan and property.
- ♦ **Tax Service Fee** - This fee is paid to a tax service agency that, for the life of the loan, each year reviews the records of the taxing agencies. If a borrower fails to pay the property taxes, the agency reports this to the lender. If the lender is paying the taxes for the borrower, the agency also obtains the tax bill for the lender.
- ♦ **Recording Fees** - These cover the cost of recording the grant deed and deed of trust reconveyance.
- ♦ **Notary Fees** - Signatures on documents to be recorded, such as the grant deed and deed of trust, reconveyance.
- ♦ **Pest Control Inspection Fee** - The buyer or seller may pay this charge, depending on local custom. The charge varies from area to area but is always negotiable.

RECURRING CLOSING COSTS

RECURRING CLOSING COSTS are the expenses the borrower also pays at closing, these expenses continue as long as the borrower owns the property, and includes items such as taxes, insurance, interest, and rents.

- ♦ **Tax Reserve** - This item is also called an impound, escrow, or trust fund account. A tax reserve is collected when the monthly loan payment will include not only principal and interest but also taxes and hazard insurance. On certain loans such as FHA and high (95 percent) LTV ratios, the collection is mandatory. In other cases, buyers may request that their payments include taxes and insurance. This is a depositor's own account. The bank does not control it. As the lender collects these funds each month, they are set aside. When the tax and insurance bills become due, the buyer/owner pays them out of the accumulated funds. To the borrowers, these funds are like their own bank account and are not under the disposition of the lender. Lenders must pay two percent interest on impound accounts when they collect.

If loan payments are to include taxes and insurance, the lender sets up a tax reserve at time of closing. The amount of reserve collected varies according to the date of the first monthly payment. Lenders use schedules to determine the tax reserve. A typical tax reserve schedule appears in Figure 14-1.

Why do lenders need what appears to be a one-month cushion? Lenders with impound accounts must pay property taxes by December 10 and April 10, or the taxes become delinquent. If the lender relied solely on the December and April payments, it might not have enough in the account to make the proper payments,

- since the borrower has a 15-day grace period. Thus, the lender has a "right" to the one-month cushion.
- ♦ **Tax Proration** - Most sales agreements provide for proration of taxes between buyer and seller. When the taxes are prorated, the seller must reimburse the buyer for any portion of the seller's taxes paid for by the buyer. The seller is responsible up to, but not including, the day of COE. Buyer is responsible from day of COE. *Proration is based on banker's date of 30 days a month, 360 days a year.*
 - ♦ **Hazard Insurance Premium.** Lenders require that the property be covered by insurance against losses due to fire, windstorm, and natural hazards. In special flood-prone areas, flood insurance may also be required. The buyer pays the premium for the first year at close of escrow.

Insurance companies in California are under the regulation of California Department of Insurance.

*☞ For complete insurance regulation details visit
www.insurance.ca.gov*

- ♦ **Hazard Insurance Reserve.** When the monthly payments include insurance, a two-month reserve is usually collected.
- ♦ **Prepaid Interest.** The loan's closing date is October 15, and the first monthly payment is December 1. The payment due December 1 covers the interest due for the month of November. The interest due from October 15 to October 31 is collected in advance at close of escrow and is called prepaid interest. If the escrow closed on October 31, there would be one day's interest if the lender funds the loan in advance of closing. For lenders, this is one of the few circumstances in which interest is collected on a calendar-day basis. In all other cases, real estate lenders use 30-day months when computing interest (as provided under the Civil Code.)

ELECTRONIC LOAN PROCESSING UNDERWRITING SYSTEMS

With the advent of the home computer and the possibilities of the Internet, it was inevitable that real estate loan processing would become electronic. Although it's quickly expanded from lenders communicating with FNMA and FHLMC, to individuals applying for a loan from their home computers, electronic loan processing still requires that the applicant's credit be approved and that the loan's collateral be appraised. But now these tasks can be accomplished in seconds and minutes rather than hours and days. Progress is measured in terms of speed and efficiency.

In 1995 FNMA offered its automated underwriting system to its loan servicers. FNMA's system followed closely behind FHLMC's loan preparation system; however, FNMA offers two levels of programming, one for lender servicers and the other for independent mortgage broker-agents, called the desktop originator-desktop underwriter. Lenders access FNMA's sophisticated loan analysis system through software purchased from FNMA. Estimated loan approval time runs from 60 seconds to 30 minutes, but the originator must fax verification information, including pay stubs, two years of W2 forms and three monthly bank statements.

Included in the process is credit scoring. The applicant's score is based primarily on data in one or more of the national repository files maintained by Experian, Equifax or Transunion. Some factors included in scoring models, include behavioral data based on number of jobs held, length of time in present home, marital status, etc. The scores on the FICO test run from 400 to 900, the higher the score, the better the credit.

Potential misuse of credit scoring has prompted the following three rules on their use:

1. Never automatically disqualify anybody due to a subpar credit score.
2. Be aware of potential errors in electronic credit files.
3. With a subpar score, closely examine the score factor codes and work with applicant to clear "fixable" items.

The property is never viewed as to condition or external factors. It is appraised by a collateral assessment, using statistical analysis, including regression analysis, and compares property features with others that have recently been sold. Success of this approach is yet to be proved.

FAIR CREDIT REPORTING ACT

The **FEDERAL FAIR CREDIT REPORTING ACT** affects credit reporting agencies and users of credit information. If a loan is rejected because of information in a credit report, the borrower must be notified and given the name and address of the credit agency.

The borrower then has the right to obtain from the agency the following:

1. All the information it has in its file on the borrower.
2. Sources of the information.
3. All the creditors to whom the agency has furnished reports within the last six months.

If an error is found, the credit agency must correct it quickly. If there is a dispute over a debt, the agency must include the borrower's side of the story, called a Consumer's Statement.

LOAN SUBJECT TO'S (SELLER LIABILITIES)

Where property is purchased "subject to" the existing loan of record, the buyer does not agree to assume primary liability for the debt. Instead, the seller continues on the obligation. Although the buyer makes the payments directly to the lender, the ***seller remains responsible for any deficiency***, if a judgment is obtained.

As a practical matter, even though the buyer is not obligated to make the payments, the buyer will naturally continue the payments in order to keep the property. This is because the debt is secured by the property, and the lender's security is held intact regardless of who makes the payments. If the buyer fails to make the payments, the lender proceeds against the property through foreclosure. The only time that the distinction between "assumption" and "subject to" becomes important is when the foreclosure results in a deficiency. If a deficiency judgment is obtained, the lender could proceed only against the maker of the note (the seller), if the buyer purchased subject to the existing loan. Had the buyer assumed primary liability for the debt, the buyer could be held liable for the deficiency.

LOAN ASSUMPTION (BUYER OR BOTH LIABLE)

A real estate loan is *assumed* when the new borrower is approved by the lender and a formal assumption agreement is executed. When a loan is assumed, the original borrower--the seller--can be relieved of responsibility, provided *release of liability* is given. If the original borrower wants to be relieved of liability, the new borrower must formally assume the loan and the original borrower must obtain a release of liability. Unless there is a complete novation, ***both parties could be liable*** on a formal assumption. Loans can be formally assumed by applying to the lender.

If the note and trust deed contain a due-on-sale clause, the FHA and the DVA must approve requests for assumption. Specific procedures exist to process assumptions. On DVA loans, the new borrower must be a veteran with appropriate entitlement if the seller is to be relieved of primary liability. Assumption under Cal-Vet is accomplished when another eligible veteran qualifies for a new loan on the same property and in the same amount as the old one, but at the then-current interest rate. Technically this is not a loan assumption, but it is a *new* loan.

LOAN PAYMENTS DUE

Loan payments are usually due on the first of each month. After the loan is closed, the borrower is notified how to make payments. There are basically two methods lenders use to collect payments. One is the *monthly billing system*. Before the first of each month, lenders mail a notice of payment due. Borrowers mail payments with the notice. The second method is the use of *coupons*. Each month, borrowers send in the monthly payment and enclose a coupon furnished by the lender.

After the first of the year, most lenders give borrowers a yearly statement for the previous year. The statement shows the principal, interest, taxes, and insurance, if included in the payments, that was paid during the year. If taxes and insurance are included in the payment, a reserve analysis is also included. The analysis calculates the amount of tax and insurance reserve that should be in the reserve account.

If there is a shortage due to a tax increase, the lender may request that the shortage be made up immediately. A more common practice is to spread the shortage over the next 12 months, along with the required increase for the future. For example, assume a borrower had a shortage of \$180 in the reserve account. Rather than demand the entire \$180 immediately, the lender would increase the monthly payment by \$15, which would make up the shortage in one year. In addition, an adjusted amount would be collected for any shortages expected in the following year. If there is a surplus in the account, the borrower may either apply it to a future mortgage payment, ask for it in cash, or apply it against the principal.

In addition to checking the reserve balances, the lender also analyzes the monthly payment. The payment may be increased or decreased if there has been a change in taxes or insurance premiums.

LATE CHARGES

When borrowers fail to make payments on time, lenders may collect late charges. The amount of the late charge and when it is collected is stated in the promissory note or deed of trust and on the payment coupon. Late charges by type of loan are as follows:

- ♦ **FHA and DVA** - Four percent of the monthly payment if not paid within 15 days of the due date.
- ♦ **Cal-Vet** - Payments are late if made after the 10th of the month. The late charge is a flat \$4.
- ♦ **Conventional Loans** - Late charges on conventional loans vary. The State of California has a civil code provision that limits late charges on single-family, owner-occupied dwellings

to six percent of the principal and interest payment. The borrower must be given a minimum of 10 days to make payment.

DEFAULTS

It is generally accepted that most lenders do not want to own the real estate that is pledged as collateral for their loans. However, defaults do occur, even though most lenders will expend every effort to qualify their borrowers in order to prevent defaults on their loan portfolios. A default is breaching of a term of a loan agreement.

When a borrower defaults, the lender exercises the acceleration clause contained in all loan documents, allowing the lender to declare the full amount of the debt immediately due and payable.

If the borrower cannot meet the payment scheduled, the lender is free to foreclose against the collateral to recover any loss. Although legally any default in a loan contract enables the lender to accelerate the debt, most lenders will seek to avoid foreclosure and arrange a plan with the borrower that will protect the interests of both parties and avoid costly foreclosure procedure.

DEFAULT IN MORTGAGE PAYMENT

The most common form of default occurs when the mortgage payments aren't made upon when they are due.

Almost all loan contracts stipulate that the regular payment is due "on or before" a specified date, but most lenders will give a **grace period**, usually from ten to fifteen days, in which to receive the regular payment.

Many loan contracts include a **late payment charge** of some specific amount that is applied if the borrower exceeds the grace period. This late payment fee is imposed to encourage promptness and to offset the extra bookkeeping costs that delinquent accounts require. Most lenders are not disturbed by payments made within grace periods, but they will take remedial action when an account consistently incurs late charges or when a borrower exceeds a 30-day delinquency period.

DEFAULT IN MAINTAINING PROPERTY

To protect the trustee holder of the property, most trust deed requires the trustor to maintain the property in a good condition. This will preserve the value of the property as collateral for the repayment of the loan.

DEFAULT IN FIRE INSURANCE PAYMENT

Again, to protect the security of the loan, most trust deeds require the trustor to maintain a basic fire insurance policy. The policy includes a "mortgage loss payee" clause in favor of the beneficiary. When a trustor/borrower fails to maintain the insurance policy in force to satisfy the beneficiary, the beneficiary may obtain a policy and charge the premium to the trustor. If a borrower fails to make such "advance" payment, the lender has the option to accelerate the loan and call the principal immediately due and payable.

Again, the impounding technique prevents most of the possible difficulties in this area, but some real estate loan arrangements allow the borrower the flexibility to pay insurance premiums independently. In such cases, the borrower is obligated to make the premium payments on time to prevent any lapse of coverage and is usually required to provide the lender with a copy of the evidence of insurance.

DEFAULT IN PROPERTY TAXES PAYMENT

Another frequently encountered default with real estate loans is nonpayment of property taxes. Although this situation is rare with residential loans due to the effectiveness of the impounding technique, it becomes a more serious problem with commercial real estate financing in which impounds are generally not required.

The nonpayment of property taxes is a technical default. Property taxes represent a priority lien over most existing liens on real estate. If a tax lien is imposed, the lender's position as priority lienholder is jeopardized. If a lender is unaware of a property tax delinquency, the collateral property may be sold for taxes. As a consequence, all realty loan agreements include a clause stipulating a borrower's responsibility to pay property taxes in the amount and on the date required. Otherwise, the lender is notified by the county treasurer, and the loan goes into default and may be accelerated.

FORECLOSURE SALE

When everything fails, the last recourse available to a lender is to pursue legal proceedings to recover the property. This foreclosure sale may be accomplished through either nonjudicial sale or judicial sale.

NONJUDICIAL FORECLOSURE PROCESS

When a borrower defaults, the lender's right can be enforced through the "**power of sale**" clause in the deed of trust. This is also called the "**nonjudicial foreclosure**" or "**trustee's sale**". In a trustee's sale, no court action is required, and the trustee is generally given the power of sale.

☞ *Trustee's sale is preferred by lenders because lengthy procedures are not required.*

The trustee's sale process is outlined below:

A lender has the legal right to receive the trust deed payment on time. The lender can institute default action after a **10-15 day** grace period. The grace period is a set number of days in which a lender will allow a payment to be late without any penalty.

The default action a lender can start is the trustee's sale. A lender has the option of a judicial foreclosure, the same remedy available with a mortgage, but this is rarely used in California. A trustee's sale of property hypothecated as a security for a debt is made possible by the provisions of the trust instrument. On default by the trustor, the beneficiary informs the trustee by a "**Declaration of Default**", which states the reason for the default. The beneficiary includes the original note and trust deed with the declaration.

The "**notice of default**" is recorded by the trustee and sent by registered or certified mail to all of the following:

- ♦ The trustor.
- ♦ Any successor in interest to the trustor.
- ♦ Junior lien holders.
- ♦ The State Controller (if there is a tax lien on the property).
- ♦ Anyone who has filed a "*request for notice*" with the county recorder.

REQUEST FOR NOTICE (PROTECTS 2ND TD HOLDERS)

When a "**REQUEST FOR NOTICE**" is recorded, the trustee is required to notify all persons who request notice if a "notice of default" is recorded on a particular property.

Any person with an interest in a particular trust deed, usually a second or third trust deed holder, should be informed if the buyer is not paying on the first trust deed. This information not only informs the junior deed holders of nonpayment on the first trust deed, but it also allows them time to prepare to purchase the trust deed at the forthcoming trustee's sale. It will also give them time to start default actions on their own junior trust deeds.

This request for notice is recorded in the county recorder's office where the property is located. If a seller takes back a second or even a third

trust deed, thereby becoming a junior trust deed holder on the property that person has just sold, that person would be wise to record a request for notice. Some request for notice forms are incorporated into the trust deed form, so the request for notice is automatically filed.

TRUSTOR'S RIGHT OF REINSTATEMENT

*A debt under a trust deed can be "**REINSTATED**" by a trustor if payment of the overdue amount is made at any time after the notice of default is recorded, but no later than five business days prior to the date of sale in the subsequent recorded notice of sale.*

Reinstatement within the five-day period preceding the sale would be at the discretion of the beneficiary and might still be allowed.

☞ Once reinstated, the trustor is again in good standing.

NOTICE OF SALE (21 DAYS)

No less than three months after the *notice of default* is recorded, a "**Notice of Trustee's Sale**" is given in the same manner as the notice of sale in a foreclosure. During the three month reinstatement period, the trustor may reinstate the loan.

The Notice of Sale is a recorded notice stating the time, place, property description and type of sale. The notice must be **published in a newspaper** of general circulation once a week, not more than seven days apart, during the 21-day publishing period. A copy of the notice must also be posted on the property and in a public place, such as the city hall.

TRUSTEE'S SALE (FINAL)

*A **TRUSTEE'S SALE** is an out of court procedure under the "power of sale clause" in the deed of trust and promissory note. The trustee's sale is held at the time and place stated in the notice of sale. At the public sale, the trustee states the purpose of the sale and describes the property to be sold. All bids must be in the form of cash or cashier's checks. The first deed holder may bid up to the total amount of the debt without cash. Because it costs the first trust deed holder nothing more than what he or she is already owed, that person will usually make the first bid. The highest bidder obtains the property and will be issued a trustee's deed. Any money more than the amount owed is reimbursed to the trustor. The new owner is entitled to immediate possession.*

At the sale itself, payment to the amount of the debt owed is by cash, cashier's check from a qualified lender or a cash equivalent designated in the notice of trustee's sale as acceptable to the trustee.

Figure 14-1 Trustee's Sale Timetable

TRUSTEE'S SALE TIMETABLE

10-15 Days Notice of Default	3 Months Reinstatement Period (Waiting Period)	21 Days Notice of Publishing	1 Day Trustee's Sale

JUDICIAL FORECLOSURE /MORTGAGE FORECLOSURE

Although mortgages are rarely used in California, it is important to understand its foreclosure procedure.

A mortgage is foreclosed by initiating a court action for judicial foreclosure, unless it explicitly includes a power-of-sale clause, as appears in a trust deed, which eliminates the need for a judicial action.

RIGHT OF EQUITABLE REDEMPTION/REDEMPTION PERIOD

The most significant difference between a mortgage and a trust deed sale is that there is **NO right of redemption** following a trustee's sale. The sale is absolutely final, and the purchaser can take possession immediately. However, if the former owner refuses to vacate the premises, an *unlawful detainer* is the legal action by which the court orders the sheriff to evict the present occupant. The purchaser at a trustee's sale must also take such an eventuality into account.

While, under a judicial foreclosure, a borrower may cure the default and reinstate the loan any time before the entry of judgment by paying the delinquencies plus costs and fees. This immediately stops the foreclosure proceedings, and the loan continues in full force and effect as though no acceleration had taken place.

A mortgagor has up to one year to redeem following court foreclosure; called "Equity of Redemption."

DEFICIENCY JUDGMENT (NOT AVAILABLE IN TRUSTEE'S SALE)

Under limited circumstances, the lender may get a judgment against the borrower if the property is sold at the court foreclosure sale for less than what is owed on the loan.

A **DEFICIENCY JUDGMENT** is the deficient difference between the money that a property brings at a court foreclosure sale and the amount

owed on the property. If a home was sold at a court foreclosure sale for \$617,000 and \$640,000 was owed on the property, a lender would have a \$23,000 deficiency judgment against the borrower. If it were a purchase money instrument, however, there would be no deficiency judgment.

During the redemption period, the borrower may remain in possession of the property but must pay rent. Sometimes a lender may take possession of the collateral under the assignment of rents provision in the loan contract, manage the property during the redemption period and apply the net proceeds to the balance owed.

INTERNET WEB LINKS

www.foreclosurefreesearch.com	Foreclosures, bank and government-owned real estate. ...
www.insurance.ca.gov	Regulations for insurance companies, and insurance licensees

CHAPTER 14 QUIZ

1. Processing an application for a real estate loan includes verification of
 - A. Employment.
 - B. Deposits.
 - C. Debts.
 - D. All of the above.
2. The last step in originating and processing loans is
 - A. Formal closing.
 - B. Qualifying the buyer.
 - C. Completing the application.
 - D. Qualifying the property.
3. The trend toward on-line loan services is
 - A. Making the real estate loan market less competitive.
 - B. Reducing the choice of financing packages for borrowers.
 - C. Not subject to government regulations.
 - D. Expected to increase in the future.
4. Which of the following would be the most important information sought by lenders about a potential borrower?
 - A. Age of the borrower
 - B. Desire for a loan
 - C. Credit history of the applicant
 - D. Overtime income
5. All of the following would generally constitute default on a trust deed with the **exception** of:
 - A. Delinquent property taxes
 - B. Failure to make loan payments
 - C. Allowing insurance policies to lapse
 - D. Placing a junior lien on the property
6. The federal law designed to prevent discrimination by lenders based on sex is known as the:
 - A. Real Estate Settlement Procedures Act

- B. Equal Credit Opportunity Act
 - C. Uniform Settlement Statement
 - D. Consumer Credit Protection Act
7. The most common cause of loan defaults is due to a borrower unable to
- A. Pay the property taxes when due.
 - B. Pay the mortgage payments when due.
 - C. Pay the property insurance premium when due.
 - D. Maintain the collateral.
8. A foreclosure will usually be initiated when
- A. A borrower has died.
 - B. A borrower has lost his or her job.
 - C. The value of the collateral has dropped below the balance of the loan.
 - D. A borrower can no longer make payments, and the value of the collateral has dropped below the outstanding balance of the loan.
9. After a judicial foreclosure sale
- A. all rights held by the trustor are terminated
 - B. The successful bidder gets fee title, free of any restrictions
 - C. The trustor has a three-month right of reinstatement.
 - D. The trustor has a one-year right of redemption
10. A trustee may initiate a foreclosure sale as a result of
- A. The provision of the California Business and Profession Code
 - B. The applicable sections of the Civil Code.
 - C. The power of sale contained in the deed of trust .
 - D. The violation of the due-on-sale clause.

*Chapter 14 Answers: 1-D, 2-A, 3-D, 4-C, 5-D, 6-B, 7-B, 8-D, 9-D,
10-C*

CHAPTER 15: NEW TAX CHANGES, HOME EQUITY LOANS, REFINANCING OR NOT AND SHOPPING FOR A LOAN



PREVIEW

There are a wide variety of loan types available to the broker for use in completing transactions. The general principle which governs the rule of interest returns is, "The greater the risk to the lender, the higher will be the interest, the shorter the maturity and the lower the ratio of loan to value." And, as an auxiliary rule, "The better the property and creditworthiness of the borrower, the more benefits will accrue to borrower, with a wider range of loan plan choices. An individual who has not saved money is forced to pay a higher price for goods purchased and real estate is no exception." (California Department of Real Estate, Reference Book)

"The greater the risk to the lender, the higher will be the interest rate"

Borrowers often are faced a common question "Should I refinance or not refinance my existing mortgage?". And if upon decided to refinance, borrowers face yet another task on choosing a right lender. This chapter will review the pros and cons on refinance and what kind of questions a borrower should ask during refinance. It will also cover the new tax law changes that a borrower should be aware and also cover the home equity loans and how to shop for a lender.

NEW TAX LAW CHANGES - TAX DEDUCTIONS TO TAKE IN 2018

WHAT'S GONE? WHAT'S STILL THERE? WHAT CHANGED?

NEW LIMIT ON DEDUCTING PROPERTY TAXES

Prior to the new tax law, taxpayers were able to deduct all of their state and local taxes, including property and income or sales taxes, from their federal taxable income. This deduction helped offset some of the cost of owning a home. However, under the new law, Americans are limited to being able to deduct just \$10,000 total on the taxes they pay to their state and local income tax, including property taxes. That means that those who pay more than \$10,000 in state and local property tax could end up paying more in taxes than they did last year.

LOWER LIMIT ON THE MORTGAGE INTEREST DEDUCTION

Under the old law, homeowners could deduct the interest you paid on a mortgage loan of up to \$1 million. The new law lowers that limit down to \$750,000 (and \$375,000 for married couples who file separately). Will this change affect you? If you are planning to take out a new mortgage on a home for more than \$750,000, then yes. Otherwise, probably not.

ELIMINATION OF HOME EQUITY LOAN INTEREST DEDUCTION

If you took out a home equity line of credit recently, or are planning to do so, this change could seriously affect you. If that line of credit was used for anything other than home improvements, then you will no longer be allowed to deduct the interest from your taxable income. It is estimated that Americans owe \$448 billion on home equity lines of credit. In the new tax law, the interest being paid on those loans will no longer be deductible unless the money was used to substantially improve your home – and there's no grandfathering in older loans, unlike with the mortgage interest deduction. That leaves a lot of people who took out home equity loans for other reasons, including paying off high-interest debt and emergency medical expenses, out of luck when it comes to lowering their tax bill.

QUALIFY FOR PASS-THROUGH INCOME

Perhaps the most significant tax change for self-employed individuals is the modification in the treatment of income from pass-through entities. Many businesses are pass-through entities, so the effect could be large and swift.

Pass-through income is generated via business income from business structures like partnerships, S corporations and sole proprietorships.

The new tax rates have a large effect on pass-through income, since this form of income was previously taxed to the end taxpayer, not at the corporate level. In 2017, this popular type of business income potentially faced the maximum tax rate of 39.6%.

That changes in 2018. If you're eligible for the pass-through deduction, 20% of taxable income gets taken off the table for tax calculation purposes. That

means if you're in the new highest 37% tax rate for 2018, this rule lowers your effective tax rate to 29.6%.

Who this affects: Many business owners who receive pass-through income including professionals like doctors and lawyers as well as some financial advisors. There is complexity, though, that might curtail this option for some, so it's important to consult your tax professional.

What to consider: Business owners might consider converting from a C corporation structure to S corporation or partnership to take advantage of the pass-through preference. Retirement plan contributions, however, may dilute the benefit of the pass-through deduction.

JOB AND MOVING EXPENSES

A lot of employers require you to buy certain things for the job, but do not reimburse you for the cost of them, including medical tests, uniforms, unions dues, home office costs, continuing education, and license and regulatory fees. In the past, taxpayers could deduct these and other job-related expenses if they added up to more than 2 percent of their gross income. The new tax law has eliminated this deduction entirely.

That means salespeople can no longer write off their travel expenses, nurses can't deduct the cost of their scrubs, and Americans who work from home can no longer deduct the cost of their home office. The doubling of the standard deduction will mitigate the loss of these deductions for some people, but those who have a lot of unreimbursed business expenses will feel the pinch.

Additionally, the new tax law eliminated the deduction for moving costs related to a new job. Under the old law, you could deduct reasonable moving expenses if the commute to your new employer from your new home was at least 50 miles further from your old home compared with where your old job was. The elimination of this common deduction has already kicked in.

NATURAL DISASTER AND THEFT LOSSES

Disaster can strike anytime – be it a fire, flood, earthquake, or even a burglary. Under the old tax system, a taxpayer could claim a deduction for losses on personal property so long as (1) the insurance company was unable to provide compensation, and (2) the total amount of those losses exceeded 10 percent of the taxpayer's adjusted gross income. More than 70,000 filers claimed casualty losses on their 2015 tax returns, resulting in \$1.6 billion in claims, and hundreds of thousands more took advantage of these deductions in the past to help alleviate their costs after a major disaster destroyed their home or damaged their possessions. Unfortunately, under the new tax law, you can no longer deduct those damages, unless the

president decides to make a disaster area declaration – something that happens in only the most extreme cases.

TAX PREPARATION FEES

The law also eliminated the deduction for tax preparation fees, which seem to increase every year. Under the old law, the fees that you paid to an accountant – or even an online tax preparation service – were tax deductible. That amount is no longer deductible from your total tax bill. However, because of all the changes in the tax law this year, it will take more time and money to prepare your taxes.

LIMITS RISE EVEN MORE FOR ESTATE AND GIFT TAXES

Federal estate taxes affect a small subset of high net worth investors now, but that number is likely to dwindle even further. That's because new tax rules double the federal estate tax exclusion to \$11 million for individuals and \$22 million for couples. Very few estates are this large, making this type of planning even more of a specialty for advisors.

Who this affects: A very small percentage of the population with an estate value at death of \$11 million.

HOME EQUITY LOANS

THE SECOND MORTGAGE

The second mortgage loan has been the source of financing of many kinds of projects for generations. Many homeowners in the past have obtained second mortgage loans on their homes to obtain funds for business ventures or investments. When those investments were successful, the second mortgage turned out to be a good idea. When those ventures were unsuccessful, the second mortgage often caused the loss of the home. Clearly, the second mortgage on the home puts the home at risk. Nevertheless it has always been a ripe source of financing for many purposes.

HOME EQUITY LOAN CONSUMER PROTECTION ACT

The home equity line of credit is a recent variant on the second mortgage, created largely as a result of changes in the tax laws.

The Home Equity Loan Consumer Protection Act, effective 1989, requires lenders who offer home equity lines of credit to meet much more detailed requirements or face stiff penalties.

- ♦ **New Disclosures** - Each lender must give to a home equity loan applicant a copy of the Federal Reserve Board's new consumer education brochure, and a sample 15-year chart of a \$10,000 line of credit tied to a prime-rate index and with a 2% margin. Although the start rate of a new loan seems attractive to the borrower, the 15-year history shows how the loan could have changed in the past and might change in the future.
- ♦ **Prohibitions** - Unilateral changes in the terms of existing lines of credit are now prohibited. Indexes selected must not be within the control of the lender.
- ♦ **Advertising** - If "*teaser rates*" are offered, the annual percentage rate (APR) must be disclosed.

The ease of mortgaging one's home to finance consumer spending can lead to excesses which jeopardize the security of the home. To help warn consumers about this danger, The Board of Governors of the Federal Reserve System has published the booklet "**When Your Home is on the Line: What You Should Know About Home Equity Lines of Credit.**" The following is quoted from that booklet.

WHAT YOU SHOULD KNOW ABOUT HOME EQUITY LINES OF CREDIT

More and more lenders are offering home equity lines of credit. By using the equity in your home, you may qualify for a sizable amount of credit, available for use when and how you please, at an interest rate that is relatively low. Furthermore, under the tax law—depending on your specific Situation - you may be allowed to deduct the interest because the debt is secured by your home.

If you are in the market for credit, a home equity plan may be right for you or perhaps another form of credit would be better. Before making this decision, you should weigh carefully the costs of a home equity line against the benefits. Shop for the credit terms that best meet your borrowing needs without posing undue financial risk. And, remember, failure to repay the loan could mean the loss of your home.

WHAT IS A HOME EQUITY LINE OF CREDIT?

A home equity line is a form of revolving credit in which your home serves as collateral. Because the home is likely to be a consumer's largest asset, many homeowners use their credit lines only for major items such as education, home improvements, or medical bills and not for day-to-day expenses.

With a home equity line, you will be approved for a specific amount of credit- your credit limit - meaning the maximum amount you can borrow at any one time while you have the plan.

Many lenders set the credit limit on a home equity line by taking a percentage (usually 75 percent) of the appraised value of the home and subtracting the balance owed on the existing mortgage.

Example:

Appraisal of home \$400,000

LTV 75%

Percentage of appraised value \$300,000

Less mortgage debt- \$250,000

Potential credit line \$50,000

In determining your actual credit line, the lender also will consider your ability to repay, by looking at your income, debts, and other financial obligations, as well as your credit history.

Home equity plans often set a fixed time during which you can borrow money, such as 10 years. When this period is up, the plan may allow you to renew the credit line. But in a plan that does not allow renewals, you will not be able to borrow additional money once the time has expired. Some plans may call for payment in full of any outstanding balance. Others may permit you to repay over a fixed time, for example 10 years.

Once approved for the home equity plan, usually you will be able to borrow up to your credit limit whenever you want. Typically, you will be able to draw on your line by using special checks.

Under some plans, borrowers can use a credit card or other means to borrow money and make purchases using the line. However, there may be limitations on how you use the line. Some plans may require you to borrow a minimum amount each time you draw on the line (for example, \$300) and to keep a minimum amount outstanding. Some lenders also may require that you take an initial advance when you first set up the line.

WHAT SHOULD YOU LOOK FOR WHEN SHOPPING FOR A PLAN?

If you decide to apply for a home equity line, look for the plan that best meets your particular needs. Look carefully at the credit agreement and examine the terms and conditions of various plans, including the annual percentage rate (APR) and the costs you'll pay to establish the plan. The

disclosed APR will not reflect the closing costs and other fees and charges, so you'll need to compare these costs, as well as the APRs, among lenders.

Interest Rate Charges and Plan Features - Home equity plans typically involve variable interest rates rather than fixed rates. A variable rate must be based on a publicly available index (such as the prime rate published in some major daily newspapers or a U.S. Treasury bill rate); the interest rate will change, mirroring fluctuations in the index. To figure the interest rate that you will pay, most lenders add a margin, such as 2 percentage points, to the index value. Because the cost of borrowing is tied directly to the index rate, it is important to find out what index and margin each lender uses, how often the index changes, and how high it has risen in the past.

Sometimes lenders advertise a temporarily rate for home equity lines - a rate that is unusually low and often lasts only for an introductory period, such as six months.

Variable rate plans secured by a dwelling must have a ceiling (or cap) on how high your interest rate can climb over the life of the plan. Some variable-rate plans limit how much your payment may increase, and also how low your interest rate may fall if interest rates drop.

Some lenders may permit you to convert a variable rate to a fixed interest rate during the life of the plan, or to convert all or a portion of your line to a fixed-term installment loan.

Agreements generally will permit the lender to freeze or reduce your credit line under certain circumstances. For example, some variable-rate plans may not allow you to get additional funds during any period the interest rate reaches the cap.

COSTS TO OBTAIN A HOME EQUITY LINE

Many of the costs in setting up a home equity line of credit are similar to those you pay when you buy a home. For example:

- ♦ A fee for a property appraisal, which estimates the value of your home.
- ♦ An application fee, which may not be refundable if you are turned down for credit.
- ♦ Upfront charges, such as one or more points (**one point equals one percent of the credit limit**).
- ♦ Other closing costs, which include fees for attorneys, title search, mortgage preparation and filing, property and title insurance, as well as taxes.

- ♦ Certain fees during the plan. For example, some plans impose yearly membership or maintenance fees.
- ♦ You also may be charged a transaction fee every time you draw on the credit line.

You could find yourself paying hundreds of dollars to establish the plan. If you were to draw only a small amount against your credit line, those charges and closing costs would substantially increase the cost for the funds borrowed. On the other hand, the lenders risk is lower than for other forms of credit because your home serves as collateral. Thus, annual percentage rates for home equity lines are generally lower than rates for other types of credit. The interest you save could offset the initial costs of obtaining the line. In addition, some lenders may waive a portion or all of the closing costs.

HOW WILL YOU REPAY YOUR HOME EQUITY PLAN?

Before entering into a plan, consider how you will pay back any money you might borrow. Some plans set minimum payments that cover a portion of the principal (the amount you borrow) plus accrued interest. But, unlike the typical installment loan, the portion that goes toward principal may not be enough to repay the debt by the end of the term. Other plans may allow payments of interest alone during the life of the plan, which means that you pay nothing toward the principal. If you borrow \$10,000, you will owe that entire sum when the plan ends.

Regardless of the minimum payment required, you can pay more than the minimum and many lenders may give you a choice of payment options. Consumers often will choose to pay down the principal regularly as they do with other loans. For example, if you use your line to buy a boat, you may want to pay it off as you would a typical boat loan.

Whatever your payment arrangements during the life of the plan - whether you pay some, a little, or none of the principal amount of the loan - when the plan ends you may have to pay the entire balance owed, all at once. You must be prepared to make this balloon payment by refinancing it with the lender, by obtaining a loan from another lender, or by some other means. If you are unable to make the balloon payment, you could lose your home.

With a variable rate, your monthly payments may change. Assume, for example, that you borrow \$10,000 under a plan that calls for interest-only payments. At a 10 percent interest rate, your initial payments would be \$83 monthly. If the rate should rise over time to 15 percent, your payments will increase to \$125 per month. Even with payments that cover interest plus some portion of the principal, there could be a similar increase in your

monthly payment, unless the agreement calls for keeping payments level throughout the plan.

When you sell your home, you probably will be required to pay off your home equity line in full. If you are likely to sell your house in the near future, consider whether it makes sense to pay the up-front costs of setting up an equity credit line. Also keep in mind that leasing your home may be prohibited under the terms of your home equity agreement.

COMPARING A LINE OF CREDIT AND A TRADITIONAL SECOND MORTGAGE LOAN

If you are thinking about a home equity line of credit you also might want to consider a more traditional second mortgage loan. This type of loan provides you with a fixed amount of money repayable over a fixed period. Usually the payment schedule calls for equal payments that will pay off the entire loan within that time. You might consider a traditional second mortgage loan instead of a home equity line if, for example, you need a set amount for a specific purpose, such as an addition to your home.

In dealing which type of loan best suits your needs, consider the costs under the two alternatives. Look at the APR and other charges. You cannot, however, simply compare the APR for a traditional mortgage loan with the APR for a home equity line because the APRs are figured differently.

- ♦ The APR for a traditional mortgage takes into account the interest rate charged plus points and other finance charges.
- ♦ The APR for a home equity line is based on the periodic interest rate alone. It does not include points or other charges.

Disclosures From Lenders - The Truth in Lending Act requires lenders to disclose the important terms and costs of their home equity plans including the APR, miscellaneous charges, the payment terms and information about any variable-rate feature. If you have not received this information from the lender, any application fees you have been charged must be refunded. You usually get these disclosures when you receive an application form, and you should get additional disclosures before the plan is opened. If any term has changed before the plan is opened (other than a variable-rate feature), the lender must return all fees if you decide not to enter into the plan because of the changed term.

When you open a home equity line, the transaction puts your home at risk. The Truth in Lending Act gives you three days from the day the account was opened to cancel the credit line. This right allows you to change your mind for any reason. You simply inform the creditor in writing within the three-day

period. The creditor must then cancel the security interest in your home and return all fees - including any application and appraisal fees paid in opening the account.

REASONS TO REFINANCE

INTEREST RATE REDUCTION

One of the best reasons to replace an existing loan with a new one is to obtain a better interest rate. If market interest rates are down, an existing loan at a higher rate can be a considerable disadvantage. A simple chart showing the payments on a loan of \$100,000 at different interest rates shows that a change in interest rate can result in a significant change in the monthly payment, with the change being slightly greater at higher interest rates.

Monthly Payments on a Thirty Year \$100,000 Loan at Different Interest Rates

<i>Interest Rate</i>	<i>Monthly Payment</i>	<i>Increase over 1% Lower</i>	<i>Increase over 2% Lower</i>
8%	\$733.77		
9%	\$804.63	\$ 70.86	
10%	\$877.58	\$ 72.95	\$ 143.81
11%	\$952.33	\$ 74.75	\$ 147.70
12%	\$1,028.62	\$ 76.29	\$ 151.04
13%	\$1,106.20	\$ 77.58	\$ 153.87
14%	\$1,184.88	\$ 78.68	\$ 156.26
15%	\$1,264.45	\$ 79.57	\$ 158.25
16%	\$1,344.76	\$ 80.31	\$ 159.88

2% RULE OF THUMB

Many advisors proffer the general rule that it pays to refinance when the interest rate will drop by at least two points (2%) and the cost of refinancing can be recaptured through savings in monthly payments within 36 months.

Using the preceding chart in applying this rule of thumb, the borrower should consider refinancing this \$100,000 loan to get a reduction from 13% to 11% if the loan costs did not exceed approximately \$5,500. Since the costs of refinancing vary among lenders, the property owner considering refinancing should shop several lenders. Many real estate brokers make a special effort to remain current about what the different lenders are offering in the market. Mortgage brokers specialize in being current about the market.

Remember, also, that the 2% rule is only a "rule of thumb" and may not be the best guide in all situations.

ESCAPING AN ARM

- ♦ **GREATER RISK** - The adjustable rate mortgage evolved from lenders' efforts to create mortgage instruments in which the borrowers would accept at least a part of the risk that interest rates might rise to levels higher than extant at the time the loan is negotiated. Lenders had been "burned" in the early 1980s when, in order to attract deposits, they had to pay interest rates on deposits higher than the rates received on existing loans, lower interest rates were offered to borrowers who would accept the risk of higher interest rates in the future by accepting variable or adjustable interest rate provisions. These loans were made even more attractive to borrowers by offering "teaser" rates for a very short term, usually until the first adjustment period. The ultimate inducement, then, was to qualify the prospective borrower on the basis of the teaser rate, enabling the buyer/borrower to qualify for a much larger loan and thus a much higher priced home.
- ♦ **REDUCING RISKS** - Property owners encumbered with ARM loans can reduce that added risk they have assumed by refinancing with a new fixed-rate loan. Clearly this procedure is most attractive at a time when market fixed rates are relatively low. Some economists suggest that 7% plus the projected rate of inflation is an attractive fixed-rate interest.

TAX-FREE CASH

- ♦ **INCREASED EQUITY** -The appreciation rate in real property values in California has been generally greater than the overall inflation rate. Homeowners who have owned their homes for several years usually find that their equities have increased enormously. It is not unusual for an owner who paid \$80,000 for a home to find that same home to be valued at \$250,000. Clearly the owner has "made" a great profit. If the owner "realizes" this profit through the sale of the home, there is a capital gain, which is subject to tax consequences unless the owner rolls the gain over into another personal residence of equal or greater value. Even the once-in-a-lifetime age exemption would not exempt all of the gain in this example. An installment sale would only defer the gain by spreading it out over a period of time.
- ♦ **TAX-FREE INCOME** - Refinancing does not usually give rise to tax consequences. Therefore, through refinancing, the owner realizes cash from this profitable investment by generating income that in most cases is tax-free income. Balloon Payment
- ♦ **The "Easy Pay" Plan** - If a loan is written with monthly payments to be made as if the loan were to be paid off over 30 years, but with the final payment of the balance due in five years, the payments are much

easier to make (lower) than if the loan were to be fully amortized with level monthly payments over five years. That is, all of the payments except the last one will be easier to make.

- ♦ **Payoff** - This property will have to be refinanced to pay off this required balloon payment.
- ♦ **Seller Carry-Back** - A seller who "takes back" a second mortgage (trust deed) may want a "short fuse"-a balloon payment to be due within four or five years. Such loans are easier to "cash out"-sell to private investors looking for short-term investments in the secondary money market. Trustors of these loans are faced with the requirement of early refinancing. Some economists recommend that a buyer/borrower try to obtain at least a seven year period before a balloon payment.

PLANNING FOR SALE

- ♦ **Assumability** - An owner planning to sell a home, or an investor planning to exchange a business or investment property, can enhance the salability of the property by encumbering the property with a large new assumable loan at attractive terms. Combine this objective with the objective of acquiring tax-free cash, and the property owner is a good candidate for refinancing.

REASONS NOT TO REFINANCE

NO REAL ADVANTAGE

- ♦ **Good Existing Terms** - A current loan written with good terms should not be disturbed when it is possible to avoid it, whenever any loan is paid off, the trustor is required to come up with cash. As a general rule there is an economic advantage to avoid coming up with cash. The **2%, 36 month rule** should be applied unless there are other persuasive reasons to refinance.
- ♦ **Prepayment Penalty** - A lender is likely to waive a prepayment penalty if the loan being paid off is at an interest rate *lower* than the current market rate. The lender would naturally like to eliminate a less profitable loan. Conversely, a lender is not likely to waive a prepayment penalty written into a more profitable (higher interest rate) loan. California Civil Code § 2954.9 provides that a prepayment penalty provision may not extend beyond five years on an owner-occupied dwelling of not more than four units. In any 12-month period during those five years the borrower may pay off up to 20% of the original principal amount without any penalty. The lender may charge up to six months' interest on any amount in excess of that 20% in that year. For loans limited by the Broker's Loan Law, the prepayment

provision may extend through seven years. Even with the limitations, however, a prepayment penalty can drive up costs of refinancing heavily. On our example of a 30-year \$100,000 loan at 10%, \$80,000 could be subject to six months' interest, or \$4,000.

- ♦ **Low Equity** - An owner who somewhat recently financed the purchase of a home with a low down-payment PMI loan probably has not built up enough equity to make refinancing reasonable unless the home has undergone enormous appreciation as a result of unusual demand influences.
- ♦ **Assumability** - FHA-insured and VA-guaranteed assumable loans, if written at favorable interest rates, should not be refinanced. On the other hand, old high-interest rate FHA and VA loans should be refinanced for lower rates.

COSTS OF REFINANCING

ORIGINATION FEE

- ♦ **Points** - Most lenders increase their yields on mortgage loans by charging loan origination fees described as "points." One "point" is one percent of the face amount of the loan. For refinancing loans, these points are deductible for federal income tax purposes only over the life of the loan. A one point fee on our \$100,000 loan would be \$1,000.
- ♦ **Insurance** - For VA-guaranteed, FHA-insured or PMI insured loans there will be either a servicing fee or an insurance fee to guarantee or insure the lender against loss in the event of default.
- ♦ **Application Fee** - Many lenders will require an initial application fee which may include an appraisal fee. These fees may not be refundable even if the lender declines the loan. All the details about the loan should be learned by the prospective borrower *before* submitting an application with a loan fee to a lender.
- ♦ **Credit Report** - Nearly all lenders pass along to prospective borrowers not only the actual cost of a credit report, but also a fee for processing and evaluating.
- ♦ **Title Insurance** - Most lenders will require a new ALTA extended coverage policy of title insurance to insure the lender's interest in the property. The premium for a policy issued by the same company which issued the previous lender's policy may be negotiated at a lower or discounted rate.
- ♦ **Attorney Fees** - Some lenders pass along to borrowers a fee to cover the lender's attorney fees which may be encountered in connection with administering the loan.
- ♦ **Prepaid Interest** - If a loan escrow is to close in the middle of a month, say July 16, and the first mortgage payment is to be due on September 1, the end of the first full month following closing, the

lender is likely to want a prepaid interest payment for the period from July 16 through July 31. Then the first mortgage payment on September 1 will include exactly one month's interest, and the payment will be a part of the "level payment plan"-the same monthly payment for the life of the loan, or until the interest rate is adjusted in the case of an ARM.

- ♦ **Warehousing Fee** - Some lenders charge a warehousing fee for holding the loan until it can be sold in the secondary money market.
- ♦ **Tax Service** - Some lenders charge a tax service fee to subscribe to services that keep lenders informed about delinquent property taxes.

SHOPPING FOR THE LOAN

HOW TO SELECT A LENDER?

One of the important decisions that a borrower will make in the loan process is to select the right loan broker to handle the finance portion of his or her transaction. Equally important is making sure that the mortgage broker knows which loan programs to recommend to his or her clients. As many as 50 to 200 different lenders are available to each loan broker. However; most brokers concentrate on 5 to 10 specific lenders and work with only those loan pro-grams that these few lenders offer. The broker works on a regular basis with relatively few lenders and knows their programs well. Yet these limited offerings may not give consumers the best possible choices. Lenders typically specialize in only a limited number of programs. If the borrower fits into one of these loan packages well, both the lender and borrower benefit. However, if the borrower is mismatched with a loan that does not best fit his or her needs, the relationship is not good from the initial loan closing.

A mortgage loan broker receives rate sheets from lenders on a regular basis or upon request. The broker should begin with the lenders with which they regularly deal. Ask for ALL the loan programs that these particular lenders typically fund. Then call other lenders and ask about their loan programs, to gain a broader range of loan types available for your clients. Not every lender handles every type of loan. A borrower may fit a particular program perfectly, but it may require the mortgage loan broker to do some extra work to find a lender who knows of the program or who handles a particular type of loan. Other criteria to review on selecting a lender with the various loan types include:

- ♦ What is the lender's ability to lock in an interest rate?
- ♦ What date or event will the loan rate tie to: application date, funding date, advertised rate?
- ♦ What loan points, fees, and costs go with which kind of loan?

- ♦ Will the lender give you references of other loan brokers who use this lender?
- ♦ What is the average time to close the loan once a processed loan is submitted?
- ♦ What loan terms and programs are available to the loan broker?
- ♦ What underwriting guidelines does the lender prefer for the loan package?

In addition to how the mortgage broker selects a type of loan and the criteria for selecting a lender, it should be noted that not all loans are available. Investors enact many different loan programs, but lenders may choose not to offer a particular loan program. Lenders become familiar with certain loan programs in light of meeting the loan program criteria and upon reviewing the foreclosure or slow-payment record on the performance of a particular loan. Thus the mortgage loan broker should check with several lenders in advance as to the availability of a particular loan program.

I

The primary consideration for selecting one conventional lender over another is often not the interest rate, fees, or programs that are available. The main criterion is often the quality of service provided by the lender. This is where an ongoing relationship can be most helpful to the mortgage loan broker. The following list may be helpful in considering the lender with which to establish a regular working relationship:

- ♦ Does the lender offer lock-in loan commitments? For what time period?
- ♦ What is the typical processing and underwriting time?
- ♦ Can you call regularly to check on the status of your loan and receive a friendly response?

INSTITUTIONAL

The great majority of real estate loans are made by a group of financial institutions referred to as "Institutional lenders" or "financial intermediaries." They provide the principal source of funds for mortgage lending. Lending institutions such as commercial banks, savings and loan associations, insurance companies, credit unions, and investment companies are financial intermediaries, economic units whose principal function is to transfer capital from those who invest funds to those who wish to borrow. This service is called "intermediation."

- ♦ **Policies** - In this role of middleman, the financial intermediary pools funds from many sources (individual savers or other short-term or long-term investors) and converts them into loans suitable to the

needs of individual borrowers. By focusing on particular markets (investment funds to purchase housing, for example) the intermediary acquires special competence in a specific field and is able to pass on cost savings and other benefits to investor and borrower alike.

- ♦ **Advantages/Disadvantages** - The "loan officers" of these institutions provide valuable services to prospective borrowers and to real estate brokers and their customers. Each loan officer, however, is marketing the loan programs of that one institution and may be promoting programs designed to meet that institution's needs in a constantly changing money market. Another advantage is that an institution may give preferential treatment to its regular customers.

MORTGAGE COMPANIES

- ♦ **Mortgage companies, or mortgage bankers**, make mortgage loans and sell them to investors. They "originate, finance, and close first mortgage loans secured by real estate and sell such loans to Institutional investors for whom the loans are serviced under a contractual relationship."
- ♦ **Loan Correspondents** - Mortgage companies operate primarily as mortgage loan correspondents of life insurance companies, mutual savings banks, pension funds, and other financial institutions. They may furnish mortgage loans to these institutions which are located in only one local area, one state, or in several states. The mortgage companies, with their loan brokerage functions, are one of the prime sources for mortgage loans on homes, on income property, and under FHA and DVA programs are the largest originators of government insured or guaranteed loans to moderate income groups.
- ♦ **Source of Funds** - Many mortgage companies have sizable funds of their own and are consistent lending sources in the mortgage market and also engage in additional business operations such as property rentals, leases, management of properties, and insurance and operate as real estate brokers. Many obtain their funds from commercial banks on short-term borrowing by obtaining lines of credit and by arranging for advances from banks against mortgage documents while such loans are in process of being sold to the ultimate purchaser of the paper.
- ♦ **Regulation** - These companies are subject to minimum supervision and have wide latitude of powers. The companies are usually free of lending limitations such as are placed on Institutional lenders and, except for inspections by an examiner in conformity with state laws, assume entire responsibility and make all decisions about their mortgage lending operations and their servicing of these loans.
- ♦ **Secondary Market Activities** - Some companies serve only as intermediaries and resell the loans as soon as they are made, under such programs as Federal National Mortgage Association, Government

National Mortgage Association and Federal Home loan Mortgage Corporation, all secondary market facilities.

- ♦ **Business Activities** - The mortgage banker is often an "importer" of funds, acting as an intermediary between out-of-state or distant investors and local borrowers, causing funds in capital-surplus areas to be transferred to capital - deficient areas such as California.
- ♦ **Lending Policies** - The prevailing policy of these mortgage companies is to deal in mortgages which are most readily salable in the secondary market. Therefore these "temporary" lenders prefer government-insured or government-guaranteed mortgages, and conventional or uninsured mortgages for which they have advance purchase commitments. Generally mortgage bankers restrict their conventional loans to selected residential and business risks, and to loans in price ranges suitable to the needs of investment firms that comprise the secondary mortgage market.
- ♦ **Application Procedure** - The mortgage banker acts as a liaison or middleman between the borrower and the lender. When a borrower seeks a loan from a mortgage banker the usual procedures are:
 - The customer fills out a loan application, assisted by a loan officer;
 - A credit report is ordered;
 - A company appraiser evaluates the property (at this stage the investor, usually an Institutional buyer, has been determined, and the appraiser is guided by standards important to the investor, e.g., new homes only);
 - The application package, including application form, borrower's financial statement, appraisal, photographs of the property, and a copy of the sale agreement or building contract is mailed to the investor;
 - The investor decides whether to accept;
 - Approval is sent to the mortgage company;
 - When specific loan conditions are met, the mortgage banker forwards funds to escrow for closing; and,
 - After closing, the key documents are sold to the investor, and the mortgage banker is ready to commence servicing the loan.
- ♦ **Advantages/Disadvantages** - The mortgage loan broker can offer to the prospective borrower a much more extensive menu of loans of many types from many lenders. The borrower can effectively "shop" more extensively for the most advantageous loan and most suitable loan from the borrower's point of view. However, a loan broker must be paid a brokerage fee for the services rendered. This fee is negotiable, and may be paid by the lender from the loan origination fee or discount points.

PORTFOLIO LENDERS

Lenders who make some loans which they do not intend to sell in the secondary mortgage money market are referred to as "**PORTFOLIO LENDERS**." These loans do not have to meet FNMA/FHLMC guidelines. For these loans, a lender may accept credit problems and may make higher risk loans at higher interest rates.

WHAT KIND OF LOAN?

Total price of a property seems to be of much less consequence to buyers than purchase terms. They shop terms. If the down-payment and monthly payments are low enough to meet their "pocketbook," price appears to be of secondary importance. The same is true in shopping for a loan.

- ♦ **Fixed Rate or Adjustable Rate** - If the borrower has sufficient income and credit position to qualify for either a *fixed* rate or an adjustable rate loan, which would be better for the borrower? Here the borrower does his own gambling. If the borrower thinks that interest rates will go up, a fixed rate loan will provide protection from rising interest rates. If the borrower expects interest rates to fall, an adjustable-rate loan will provide interest savings.
- ♦ **Shopping for an ARM** - Because the adjustable-rate loan requires that the borrower assume the risk that interest rates might rise, the borrower should expect a lower interest rate, not counting the initial "teaser" interest rate that applies only for the first few months. To make comparisons, look at the APRs, not just the interest rates.
 - **Shop Indexes** - The "cost of funds" index is the slowest changing-preferable if interest rates are lower at the time but might go up. The U.S. Treasury bill index is the fastest changing-preferable if interest rates are high at the time but are expected to go down.
 - **Shop Margins** - The margin is the percentage added to the index to arrive at the applicable interest rate of the loan after the initial "teaser" rate is terminated at the first adjustment period. Margins can be 2%, 2.5%, 3%, etc. A high margin with a low index could be preferable to a low margin with a high index, or vice versa.
 - **Shop Caps** - Some ARMs provide annual interest rate caps - the maximum annual interest rate increase, example 2%; and some ARMs provide lifetime interest rate caps, example five percent. Some ARMs have payment caps, for example 7% maximum annual increase in the payment, regardless of interest rate increases.

GOVERNMENT LOANS

FHA and DVA loans - The emergence of FHA-insured and DVA-guaranteed home loans had a tremendous influence upon the changing pattern of demand for loan funds and home loan practices. Historically they have offered the borrower a lower rate of interest, highest ratio of loan to appraised value and longest maturity. However, since December 1, 1983, HUD no longer controls FHA-backed interest rates; they are free to float to market rates. DVA-backed mortgages still have interest rates controlled by the DVA Administrator. With the exception of new tract sales, usually more paper work is involved in obtaining government-backed loans and more time is consumed in their processing. In periods of tight money they may be almost unobtainable or certainly available only if the seller is willing to discount at an extremely high rate.

CONVENTIONAL LOANS

Where the borrower has a substantial down payment and time is important, conventional loans offer advantages even though the maturities may be shorter and payments and interest rates may be higher, especially when a fixed-rate mortgage is sought. These loans usually have shorter processing time, more flexible terms, can be had on a wider variety of properties, and, overall, cost the borrower less in total interest payments. Laws affecting the ratio of loan to value vary among the different conventional lenders or financial institutions.

SELECTION OF A CONVENTIONAL LENDER

The selection of a proper conventional lender for a client is an involved process and should be done with great care. A real estate salesperson should look at all of the conventional lenders and not just at the interest rate. The salesperson who selects a lender based only on the interest rate may be doing a disservice to his or her client.

Also, the policies of a conventional lender can change from time to time. One reason for this change may be that the lender has a commitment from a different investor and the underwriting guidelines of that investor are different, thus the lender must change its policies. So it is important, then, for you to check the conventional market on a continuing basis, for what was true last week may not be true this week.

When dealing with the conventional mortgage, one thing must be kept in mind: because a client is rejected by one conventional lender does not mean that the client will be rejected by all of the conventional lenders. Each lender has its own set of rules for accepting or rejecting a loan application. This is not true for VA or FHA loans. If either the VA or the FHA rejects the

application, there is usually little hope of getting the application approved by the other.

In order to compare lenders, you have to know what items to look for. Here are some of the main items to check out and compare:

- ♦ **Interest rate** - The interest rate is the one item that immediately comes to mind when discussing differences between lenders. Interest rates frequently change for such reasons as demand, supply, risk, competition, and so on. There is no set pattern as to how often interest rates can change. They can change weekly or even daily. Interest rates also vary according to the type of property and loan-to-value ratio. For example, a 95% loan may command a higher rate than an 80% loan because of the higher risk.
- ♦ **Loan fees** - The fee charged on loans is another item that each lender must determine. Loan fees on an 80% loan typically vary from 0 to 2% of the loan amount. Higher loan-to-value ratio loans (90 to 95 percent) carry higher loan fees. Most lenders offer tiered pricing, with points increasing as interest rates decrease. For instance, if borrowers want to secure a 7% rate, they may pay two points, while the points-sensitive borrower may pay zero points but accept an 8 to 9% interest rate. The type of property may also affect the loan fee. For example, a lender may decide to charge a higher loan fee on three- to four-unit dwellings as opposed to an owner-occupied single-family home.
- ♦ **Loan-to-value ratio** - Conventional lenders are able to make loans up to 95 percent, and in special cases 97% on one-to-four-unit properties. As a matter of policy, many lenders lower their loan-to-value ratios on three- and four-unit properties, non-owner-occupied properties, land loans, and refinance loans. In some cases, conventional lenders will make 100 to 125% loans, but these are not considered "standard loans" and often carry excessive loan fees.
- ♦ **Maximum loan amounts** - Each lender sets its maximum loan amount. The loan amounts vary by type of property. For owner-occupied residential properties of one to four units, many lenders use the Fannie Mae/Freddie Mac loan maximums discussed in Chapter 7. These are "conforming" loans, based on the lenders' ability to sell the loans to FNMA/FHLMC, which set maximum loan limits. These loan limits change each year, and a borrower should call a loan officer or mortgage broker to determine the current limits. Other conventional lenders specialize in jumbo loans (loans greater than the Fannie Mae and Freddie Mac limits) for higher-priced homes.
- ♦ **Prepayment penalties** - As already noted, most conventional lenders are no longer charging prepayment penalties. When they do, the typical prepayment penalty on a conventional loan is six months' interest on the amount prepaid that exceeds 20% of the original amount of the loan. However, penalties vary with the lender. They can

even be eliminated in some cases. For example, a lender may waive the prepayment penalty if the seller has the new buyer finance the purchase with the same lender.

Finally, there is no reason to charge penalties to pay off an adjustable rate mortgage (ARM), since the rate varies with the interest rate market so that the lender need not be burdened with finding productive use of loans that are prematurely repaid. (In the past, lenders paid off on high-interest loans in a low-interest environment charged penalties to offset some of the interest losses and loan origination costs.) Under California law, prepayment penalties cannot be imposed beyond 5 years.

- ♦ **Borrower qualifications** - There is no standard way to qualify a borrower, and each lender determines its own standards. Some lenders are very strict in qualifying a borrower, while others may be more lenient. Many conventional lenders use the Fannie Mae/Freddie Mac guidelines.
- ♦ **Types of loans** - A few conventional lenders make only fixed rate loans. Other lenders offer adjustable rate loans, on which the interest rate is subject to change according to a specified index. Adjustable rate loans, for example, have been used since 1923 by the California Department of Veterans Affairs. Other types of Loans are also available, such as convertible rate, buy-down loans, and, in some cases, reverse mortgages.
- ♦ **Type of property** - Lender policy determines the type and quality of property the lender is willing to accept as security for the loan. Does it lend on one- to four-unit properties only, or does it lend on larger apartment houses, and commercial and industrial property? Will the lender make a loan on a steep hillside lot?
Some lenders do not, because of the slide risk. There are other property standards that a lender sets, and these standards can vary greatly from one lender to the next, as long as they are not illegally discriminatory.
Policies and standards set by conventional lenders are not static. A conventional lender can change its property and borrower standards the same way it changes the interest rate. These changes are made to accomplish certain goals. If a lender has a surplus of money, it has to find a way to make more loans. It may lower its property or borrower standards. Or it can lower the interest rate or change some other policy that will enable it to make more loans. If the conventional lender wants to reduce loan demand, it could tighten up on its standards and increase the interest rate and loan fees, but its policies and standards cannot be discriminatory under fair housing laws.

QUESTIONS FOR THE BORROWER TO ASK

LENDER'S QUESTIONS

A lender asks a prospective borrower many questions before making a commitment to make a loan. The answers are submitted as a part of the loan application, usually along with an application fee, which may include charges for a property appraisal and a credit report. This application fee is usually not refundable, even if the lender declines to make the loan. The loan application is not designed for persons merely inquiring about real estate loans who have yet to reach a decision to buy or finance. It is for the person who presumably will follow through and borrow, providing a loan is approved by the lender.

☞ Many loan applications to many lenders is not an effective way to "shop" for a loan.

BORROWER'S QUESTIONS

The following is a check list of questions for the borrower to ask before making a formal loan application and paying an application fee to the lender.

- ♦ **Borrower's Decision** - The prospective borrower will not always get satisfying answers to all of the questions asked, but by comparing the answers of several lenders the prospective borrower has the information needed to make informed decisions about a loan application.
- ♦ **Borrower's Checklist** - (Questions to ask before making a loan application and paying an application fee to a lender)
 - Fixed-rate APR?
 - Adjustable-rate APR?
 - Index used?
 - Margin?
 - Frequency of rate adjustments?
 - Loan origination fee?
 - Is the origination fee negotiable?
 - Discount points?
 - Are the discount points negotiable?
 - Credit report fee?
 - Appraisal fee?
 - Other closing costs?
 - Loan application fee? II What does the application fee cover?
 - Balloon payments?
 - Can interest rates be locked in? At what cost?
 - What are the lender's qualifying ratios?
 - Will the lender accept a CLTA title insurance policy?

- Assumability? Under what terms?
- Prepayment penalties?

CHAPTER 15 QUIZ

1. Replacing an existing loan with a new one is called:
 - A. Assumption
 - B. "Subject to"
 - C. Refinancing
 - D. Prequalifying
2. Common reasons for refinancing include:
 - A. Paying off a balloon payment
 - B. Getting a lower interest rate
 - C. Turning equity into tax-free income
 - D. All of the above
3. As a general rule, it pays to refinance when the new interest rate will be at least ____ % lower and the costs will be recaptured from lower monthly payments within ____ months:
 - A. 5, 24
 - B. 2, 36
 - C. 2, 24
 - D. 1, 36
4. Costs of refinancing commonly include:
 - A. New title insurance policy
 - B. Application fee
 - C. Points
 - D. All of the above
5. The home equity loan or line of credit is a form
 - A. Second mortgage
 - B. Consumer loan
 - C. Unsecured loan
 - D. Home acquisition indebtedness
6. Refinancing can enhance the salability of a property:
 - A. With a large new assumable loan on good terms
 - B. Only for a speculative investor
 - C. By getting an ARM with a low teaser rate

- D. Almost never
7. Reasons not to refinance include:
- A. Good existing terms
 - B. Prepayment penalties
 - C. Little increase in equity since previous financing
 - D. All of the above
8. The home equity loan or line of credit originated because of:
- A. Increasing scarcity of consumer credit
 - B. New federal rules on deductibility of interest
 - C. Problems with foreclosures on balloon payments
 - D. Widespread fear of refinancing
9. The maximum amount of a home equity line of credit is usually:
- A. The appraised value of the home
 - B. 75% of the appraised value of the home
 - C. 75% of the appraised value of the home, less existing mortgage debt
 - D. \$100,000
10. For a home equity loan or line of credit, the Truth in Lending law:
- A. Does not apply
 - B. Provides a three-day right to cancel
 - C. Requires disclosure of APR, payment terms, and variable-rate features
 - D. Both B and C

Chapter 15 Answers: 1-C, 2-D, 3-B, 4-D, 5-A, 6-A, 7-D, 8-B, 9-C, 10-D

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