

Fourteenth Edition

Essentials of **Real Estate Finance**

David Sirota, PhD • Doris Barrell, GRI, DREI, CDEI

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Preface

Welcome to the intriguing and exciting world of real estate finance. The past few years have seen tremendous changes in the real estate financing market. New programs seemed to appear almost daily as everyone from those in the Oval Office to the local corner bank worked to keep homeowners from losing their homes to foreclosure.

In October 2008, Congress passed the first of the rescue bills aimed at easing the great credit crunch that was brought about by the burst bubble of the burgeoning real estate markets of the early part of this century. The new bill directed \$700 billion to help lenders dispose of their worthless defaulted loans and to restart their lending activities. Over the next three years, the government created numerous programs designed to assist homeowners at risk of foreclosure due to increased monthly payments and unemployment. The recovery, now in process, is again based on long-term, fixed-interest-rate loans made to qualified borrowers financing reasonably evaluated real estate properties.

Although loans can still be secured through the internet, underwriters will be screening these loans carefully to make sure the borrowers have verifiable credit histories, and the collateral properties are evaluated accurately. Nothing-down, interest-only, and variations of subprime loans are no longer acceptable. Lenders must now adhere carefully to the underwriters' requirements in order to sell their real estate loans in the secondary markets.

To a great extent, the U.S. economy depends on the ability of many individuals to comprehend and use real estate finance. Each participant need not know everything about all phases of financing real estate, but those who do understand the process are more likely to achieve success.

People have depended, in ever-increasing numbers, on banks, thrift institutions, and life insurance companies to lend them the dollars with which to buy a piece of America. Some people bought large pieces, and some grouped together to buy even larger ones, but most people just bought the little piece they call home.

In this new edition, you will find numerous revisions and additions that reflect the many changes that have occurred in the real estate financial market in recent years. The most commonly used forms have been moved to the appendices, including the new Loan Estimate and Closing Disclosure forms, which have been mandated for use on August 1,

2015. Of course there will always be new changes, especially as the market slowly works its way out of the overwhelming foreclosure problem. It is critically important for instructors and students to keep up-to-date with their own research. The websites listed in each chapter provide excellent resources.

Doris Barrell
David Sirota

In Memoriam

On October 2, 2014, the world of real estate lost one of its finest educators, practitioners, and authors. Dr. David S. Sirota passed away in Green Valley, Arizona, where he had enjoyed several years of retirement with his wife, Roslyn. His influence on thousands of students can never be fully measured, and he will be greatly missed by his many friends, former students, and colleagues throughout the real estate industry.

ACKNOWLEDGMENTS

Dr. David Sirota had a combined 40 years of field experience as a real estate agent, broker, appraiser, and consultant, plus an academic background culminating in a PhD from the University of Arizona in Area Development. He has said, “To be extraordinarily successful, it’s not enough to know how the system works, but why it does. Then you can be in a position to utilize it for your own highest benefits.”

Dr. Sirota taught real estate subjects at the University of Arizona in Tucson, the University of Nebraska in Omaha, Eastern Michigan University in Ypsilanti, National University in San Diego, and California State University in Fullerton. He held the Real Estate Chair at Nebraska and was a visiting professor at the University of Hawaii. He was involved as a consultant in the development of a congregate care center in Green Valley, Arizona, and acted in a consultant capacity for individuals and developers. He was a founding member of the Real Estate Educators Association, securing one of its first DREI designations. Dr. Sirota was also the author of *Essentials of Real Estate Investment* and coauthor of *California Real Estate Finance*.

Doris Barrell, GRI, DREI, CDEI, has been in the real estate business for over 30 years, working first for a builder/developer, next as a general brokerage agent, and then for nine years as managing broker for a 60-agent office in Alexandria, Virginia. She became a full-time instructor in 1996, bringing her wealth of real-life experience into the classroom, where she taught courses in finance, agency, fair housing, ethics, and legislative issues.

In addition to *Essentials of Real Estate Finance*, Ms. Barrell is the author of *Real Estate Finance Today*, *Ethics in Today’s Real Estate World*, *Know the Code*, and *Everyday Ethics in Real Estate*; coauthor of *Reaching Out: The Financial Power of Niche Marketing* and *Fundamentals of Marketing for the Real Estate Professional*; and consulting editor for *Reverse Mortgages* and *Virginia Practice and Law*. She served as a teaching consultant to the International Real Property Foundation, bringing real estate education to countries in Eastern Europe and Southeast Asia for over 10 years. Ms. Barrell recently retired “with honors” from NeighborWorks® America, where she prepared course materials and taught classes at NeighborWorks® Training Institutes throughout the United States. She also developed the “Expanding Housing Opportunities” course for NAR, which she taught in addition to Train the Trainer classes for NAR instructors.

CONTRIBUTORS

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The Nature and Cycle of Real Estate Finance

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- evaluate the importance of the construction industry to the national economy;
- define and illustrate the concepts of collateralization, hypothecation, and leverage;
- differentiate between the primary and secondary financing markets;
- list important factors that affect real estate cycles; and
- discuss government plans for stimulating the economy.

American Recovery and Reinvestment Act of 2009 (ARRA)

American Taxpayer Relief Act of 2012 (ATRA)

baby boomers

collateral

Consumer Financial Protection Bureau (CFPB)

disintermediation

echo boomers

equitable title

Generation X

Home Affordable Modification Program (HAMP)

Home Affordable Refinance Program (HARP)

hypothecation

leverage

mortgage-backed securities (MBSs)

Mortgage Forgiveness Debt Relief Act of 2007

primary market

real estate cycle

robo-signing

secondary market

shadow inventory

short sale

subprime market

Taxpayer Relief Act of 1997 (TRA '97)

Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

There is no getting away from real estate: We farm on it, live on it, work on it, build on it, fly away from and return to it, and we ultimately are buried in it.

No one can question the importance of real estate in our lives.

Complementing its physical importance is the economic impact of real estate on our lifestyles. The industrial and commercial activities of our nation are completely dependent on the land and its natural resources for their very existence. Our society cannot function without food, lumber, minerals, water, and other parts and products of our land.

Many of us are involved, either directly or indirectly, in some activity concerning real estate. Salespersons, brokers, farmers, miners, engineers, surveyors, land planners, homebuilders, furniture manufacturers, and paint purveyors—all of these people and more depend on real estate and its use for their livelihood. Millions of persons are engaged directly in construction activities in the United States, with literally millions more providing them with the materials and peripheral services essential to their work.

Nowhere is the economic impact of the real estate market better shown than during the economic crisis that began in 2007. As the overall real estate market began to decline and it became impossible for many people to sell or refinance their homes, the rate of foreclosures began to climb all over the country. The overall picture remained grim until 2012 when the housing market began to show some signs of renewal in many parts of the country. With the exception of the “sand belt”—Florida, Arizona, and Nevada—and the states affected by Hurricane Sandy, the rate of foreclosures began to decline and continued into 2013 and 2014. This was partially due to a higher acceptance of short sales by lenders. Unlike recoveries from previous recessions, the rate of employment has remained low, but there has been a gradual increase in the number of housing starts, which is an essential element to the overall economic picture.

THE NATURE OF REAL ESTATE FINANCE

The construction industry is vital to our country’s economic well-being and is therefore a significant factor in real estate finance. Any changes in its activities soon affect everyone. A building slowdown results in layoffs and cutbacks, while increased activity stimulates production and services in the many areas associated with the industry. Little construction is attempted that is not paid for by loans secured from the various sources of money for real estate finance. In fact, most real estate activities rely on the availability of borrowed funds.

The popular saying “as goes the construction industry, so goes the economy” was illustrated in the economic crisis that began with the downturn in the housing market in 2007. The number of housing starts kept falling, especially for new single-family homes. The first hopeful signs of a return to safe financial ground were not seen until 2013–2014 when single-family building began to slowly increase and multifamily starts actually reached their highest level since 1998.¹

1 Joint Center for Housing Studies of Harvard University, “The State of the Nation’s Housing Report 2013,” Joint Center for Housing Studies, www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013.pdf (accessed October 28, 2014).

Credit System Economy

We all recognize that our society is credit oriented. We postpone paying for our personal property purchases by using credit cards and charge accounts. Credit expands our ability to own goods that in turn enhance our lives.

The credit concept of enjoying the use of an object while still paying for it is the basis of real estate finance. Financing a real estate purchase involves large sums of money and usually requires a long time to repay the loan. Instead of revolving charge accounts or 90-day credit loans for hundreds of dollars, real estate involves loans of thousands of dollars, repayable for up to 40 years.

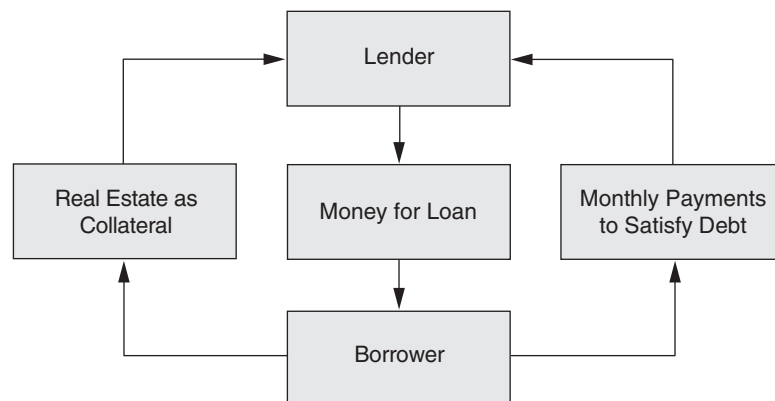
The long-term nature of real estate loans complements the holding profile of the major financial lenders. Furthermore, the systematic repayment of real estate loans, usually in regular monthly amounts, creates the rhythm that enables lenders to collect savings and redistribute funds to implement continued economic growth.

However, this rhythm can be interrupted when there is a prolonged period of **disintermediation**; that is, when more funds are withdrawn from financial institutions than are being deposited. This results in a net loss of deposits, a cutback in lending, and a slow-down in the economy. There is continuous, vigorous competition for the use of money among individuals, industry, and government. That is why we need the Federal Reserve (the Fed) and the secondary markets to redistribute funds nationally and provide a constant flow of cash.

Financing Relationships

The nature of the financing relationship can be described in three ways. In its simplest form, real estate finance involves pledging real property as **collateral** to back up a promise to repay a loan. As illustrated in Figure 1.1, a building and the land on which it stands are pledged to a lender as the borrower's guarantee that the terms of a loan contract will be satisfied. If a borrower defaults on repayment promises, the lender is legally able to foreclose on the real estate and sell it to try to recoup the loan balance.

FIGURE 1.1 Financing Real Estate with Collateral



Until the borrower repays the lender in full, the real estate is the borrower's collateral or security that the debt will be repaid.

A second way to describe real estate finance is **hypothecation**. The borrower remains the legal owner and retains rights of possession and control while the lender secures a “bare title,” a “naked title,” or an **equitable title** in the property. An equitable title confers no rights to the lender except after a loan default when the legal title may be attained through foreclosure. In other words, under hypothecation, the lender has only a security, or equitable, interest in the collateral property, which ends when the loan is paid in full.

Hypothecation is found in other situations as well. A tenant may pledge leasehold rights as collateral for a loan. A lender may pledge rights in a receivable mortgage, deed of trust, or contract for deed as collateral for another loan. A life tenant can acquire a loan on beneficial rights as well as remainder rights. A farmer can pledge unharvested crops as collateral for a loan. In each of these cases, and others of similar design, the borrower retains possession, control, and use of the collateral but capitalizes on its value by borrowing against it.

Leverage is the third way to describe real estate finance. Leverage is the use of a proportionately small amount of money to secure a large loan for the purchase of a property. Buyers invest a portion of their money as a down payment and then leverage by borrowing the balance needed toward the full purchase price.

The quality and quantity of leverage are important topics. Buyers may be asked to invest 3, 5, 10, or even 20% of the purchase price before being eligible to borrow the balance. As a result of tightened qualifying standards due to the financial crisis, today’s buyers may be asked to provide a much larger down payment than in the past. The minimum down payment for most conventional loans today is 5%, although FHA remains at 3.5%. The degree of leverage depends on the specific situation and the type of loan desired. These varying cash requirements dramatically affect a buyer’s ability to purchase property. The use of leverage to purchase investment property generally increases the return on cash invested to an amount substantially higher than paying all cash.

MORTGAGE LENDING ACTIVITIES

Underlying and forming the foundation for mortgage lending is the concept of savings. These savings are loaned to borrowers from whom additional earnings are produced for the lenders in the form of interest. These earnings are then used in part to pay interest to the savers on their deposits.

Most loans for real estate are made by financial institutions designed to hold individuals’ savings until they are withdrawn. These primary market institutions include the following, among others:

- Commercial banks
- Savings banks
- Life insurance companies
- Credit unions

FIGURE 1.2 Mortgage Debt Outstanding, End of Q1 2014 (Millions of Dollars)

By Type of Property	
One- to four-family residence	\$9,851,321
Multifamily residence	939,036
Nonfarm, nonresidential	2,294,141
Farm	<u>183,000</u>
Total	\$13,267,498
By Type of Holder	
Major financial institutions	\$4,421,126
Federal and related agencies	4,977,000
Mortgage pools and trusts	2,907,125
Individuals and others	<u>962,247</u>
Total	\$13,267,498

Source: www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm

The loans originated by the primary market lenders are then packaged and sold to the secondary market, which includes the following:

- Fannie Mae
- Freddie Mac
- Ginnie Mae
- Federal Home Loan Bank
- Private investors

The scope of the mortgage lending activities of various sources of funds is shown in Figure 1.2.

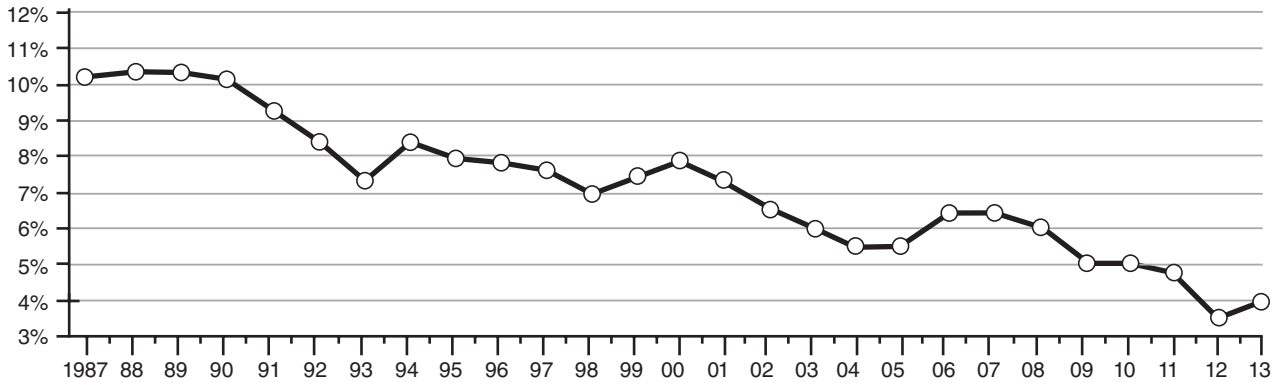
The total amount of mortgage loans outstanding at the end of Q1 2014 was more than \$13 trillion, down from a total of \$14 trillion in 2009. Notice that almost 75% of all loans are made for one- to four-family residential properties, a dramatic testimony to the importance of housing in the real estate market.

The price of real estate fluctuates over time, depending on changing market conditions. Most buyers do not have the cash required for real estate purchases. They must borrow to complete their acquisitions. If the sources for these loans were to be limited to any large extent, fewer properties would be developed and fewer would be sold. Shortages of funds for mortgage lending affect every level of the construction industry, with serious ramifications throughout the total national economy.

Interest Rates

In the late-1980s, interest rates on real estate loans were at double-digit levels, as shown in Figure 1.3. This effectively eliminated a major portion of the participants in the real estate market. To meet this emergency, a broad range of creative financing arrangements were

FIGURE 1.3 30-Year Fixed-Rate Mortgage Interest Rates



Source: www.freddiemac.com

invented to allow market continuity. These arrangements included partnerships between lenders and borrowers (called participation financing, which is used mostly in commercial real estate), variable-interest-rate loans, and variable-payment loans, all designed to relieve borrowers' burdens and permit lenders to stay in business. As the decade progressed, interest rates fell almost as rapidly as they had risen, and the demand for basic fixed-rate mortgages returned. This reduction in interest rates, to between 6 and 8%, resulted in a sharply increased demand for mortgage refinancing, and the focus of the lenders shifted from loans for purchasing property to loans for refinancing existing high-interest adjustable-rate and fixed-rate loans. In addition, relatively low interest rates fueled a sharp rise in real estate activity. As interest rates continue to drop in the second decade of the 2000s and there are more loan modifications with these lower interest rates, lenders were once again swamped with refinancing requests. Midway through 2014, the average interest rate for a fixed-rate, 30-year mortgage is slightly over 4%.

Financial Crisis

In the late 1990s and early 2000s, the **subprime market** more than doubled offering higher qualifying ratios, hybrid ARMs with artificially low initial payment schedules, and more liberal qualifying standards. Fannie Mae and Freddie Mac conforming loans also became available in many different forms using liberal qualifying standards and long-term risky loan products.

As the overall housing market boom began to decline in 2006, the subprime market was the first to crash, but by 2007, Fannie Mae and Freddie Mac were also in trouble. Borrowers found themselves unable to pay their sharply increased mortgage payments as adjustable-rate mortgages began to reset at higher rates. Refinancing was no longer an option because housing values were declining, and the slow market made it very difficult to sell. By 2007, more than 1% of all households were facing foreclosure, with projections of at least 3% by 2010. A Mortgage Bankers Association survey in August 2008 showed 9.2% of all U.S. mortgages were either delinquent or in foreclosure. By September 2009,

this had risen to 14.4%. On a more optimistic note, in April 2010, RealtyTrac® reported a 2% drop in foreclosures from the previous year, the first annual decline in five years.

The decline continued in 2011 but was mainly attributed to the slowdown in the way many lenders handled foreclosure documentation after being criticized for taking shortcuts such as **robo-signing** (in which a bank official signs thousands of documents without verifying the information). As the banks began to move past these problems, the rate of foreclosures began to once again increase. According to financial analysts from CoreLogic, as of June 30, 2011, 22.5% of U.S. homeowners were “underwater” (i.e., they owed more than their house was worth) on their mortgage. The U.S. Foreclosure Market Report, published by RealtyTrac®, showed that one in every 213 U.S. housing units had a foreclosure filing in the third quarter of 2011.

The National Association of REALTORS® forecast for 2013 showed that the **shadow inventory** (i.e., houses that were delinquent or in foreclosure) represented about one-third of the market in 2010 and 2011. This number dropped to around 25% in 2012 and was projected to fall to single digits by 2014. In the January 10, 2014, issue of *REALTOR® Magazine*, Mark Fleming, the CEO of CoreLogic, was quoted as saying that the shadow inventory, which is also referred to as the “pending supply,” had fallen to its lowest level since August 2008, down 24% from the previous year.

The National Mortgage Settlement, announced in February 2012, is believed to have played a major role in the drop in the number of foreclosures. This was a joint state/federal settlement with five of the largest mortgage servicers in the country: Ally/GMAC, Bank of America, CitiMortgage, JPMorgan Chase, and Wells Fargo. The settlement, which provided nearly \$25 billion in relief to distressed borrowers and direct payments to states and the federal government, was the largest multi-state settlement since the tobacco settlement in 1998.

Another major factor in the reduction of foreclosures was the growing acceptance by lenders of short sales. After careful analysis, many lenders realized that accepting a determined loss from a **short sale**, in which the lender accepts less than the actual payment due, could result in a lesser amount of loss than carrying the property through foreclosure with limited prospects for resale.

Plans for Stimulus to the Ailing U.S. Economy

On February 17, 2009, President Obama signed into law the **American Recovery and Reinvestment Act of 2009 (ARRA)**, which is also called the Stimulus Bill. Important components of the act included federal tax cuts, expansion of unemployment benefits, other social welfare provisions, and domestic spending in education, health care, and infrastructure. Some of the credits and provisions of the act that were due to expire at the end of 2010 were extended by the Tax Relief and Job Creation Act of 2010 and again later by the American Taxpayer Relief Act of 2012.

On February 18, 2009, President Obama announced his Homeowner Affordability and Stability Plan, which included the Making Home Affordable (MHA) program. The MHA program offered assistance to seven to nine million homeowners making a good-faith effort to make their mortgage payments through loan modification or refinancing. The **Home Affordable Modification Program (HAMP)** is a key component of the MHA initiative and has been extended through 2015.

The original HAMP actions taken included

- expanding the Fannie Mae, Freddie Mac, and FHA loans limits up to \$729,750;
- launching a \$23.5 billion Housing Finance Agencies initiative to help state and local housing finance agencies;
- supporting the First-Time Homebuyer Tax Credit; and
- providing over \$5 billion in support for affordable rental housing through low-income housing tax credit programs and \$2 billion in additional support for the Neighborhood Stabilization Program (NSP) to restore neighborhoods hardest hit by concentrated foreclosures.

On February 19, 2010, the government announced the \$1.5 billion Hardest-Hit Fund for state housing financing agencies (HFAs) in the nation's hardest-hit housing markets (\$600 million more were added on March 29, 2010, for an additional five HFAs).

In April 2010, enhancements were made to HAMP. The program modifications expanded flexibility for mortgage servicers and originators to assist more unemployed homeowners and those who owe more on their mortgage than the home is worth because of large declines in home values in their local market. This second chance was anticipated to help three to four million struggling homeowners in 2012. The **Home Affordable Refinance Program (HARP)** provides refinancing assistance for some homeowners who are not eligible for HAMP. This program has been extended to December 31, 2015.

In July 2010, President Obama signed into law the **Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)**. This lengthy piece of legislation contains many provisions that are anticipated to restore responsibility and accountability to the financial system. Title III of the act abolished the Office of Thrift Supervision, transferring its power of holding companies to the Federal Reserve, state savings associations to the FDIC, and other thrifts to the Office of the Comptroller of the Currency. The amount of deposits insured by the FDIC and the National Credit Union Share Insurance Fund was permanently increased to \$250,000.

Title X of the act established the Bureau of Consumer Financial Protection, also called the **Consumer Financial Protection Bureau (CFPB)**. The CFPB is housed within the Federal Reserve but operates independently. Its mission is to set rules and regulations for any business that provides financial services for consumers. The CFPB will be discussed in more detail in Chapter 3.

For more information on the Dodd-Frank law, see <http://banking.senate.gov/public/>.

Local Markets

Real estate is a local market in that it is fixed in place. It is impossible to move a parcel of land. As a result, any activities are done to and on the property. A building is constructed on the lot. Utilities are brought to the property and taxes are imposed on it. A real estate loan is made on a property, usually by a local lender or the local representative of a national lender.

The activities of the local real estate market, especially as they influence property values, are vital to the activities of the local real estate lenders. Regional, national, and

international economic and political events have an indirect effect on specific real property values. However, the immediate impact of local activities on individual properties most directly affects their value.

For example, police power decisions involving zoning regulations can dramatically raise individual property values, while just as dramatically lowering neighborhood property values. Political decisions concerned with community growth or no-growth policies, pollution controls, building standards, and the preservation of coastline and wildlife habitats can significantly alter a community's economic balance and property values.

In times of economic distress, as evidenced by high interest rates and/or unemployment, local financial institutions decrease their mortgage-lending activities. This decrease adds to the downward cycle. In good times, their lending activities increase to serve the growing demand.

National Markets

When the demand for mortgage money is great, local lenders may deplete available funds. In an economic slump, these lenders may not have any safe outlets for their excess funds. A national mortgage market was developed to balance these trends.

Fannie Mae, Freddie Mac, and Ginnie Mae are the major participants in a viable national market for real estate mortgages. They, and other groups of investors, are collectively known as the **secondary market**. Loans created by local lenders, thrifts, banks, mortgage bankers, and others, known as the **primary market**, are purchased by these "second" owners who, in turn, often package these loans into mortgage pools. Proportionate ownership of these mortgage pools is then sold to investors in the form of securities called **mortgage-backed securities (MBSs)**.

In this manner, the secondary mortgage market participants act to stabilize the real estate market by shifting funds from capital-excess areas to capital-deficient areas. Although they were originally designed to provide safe investments for the purchasers of their securities, recently this has not necessarily been the case. The purchase of packages of "junk" loans that did not provide a safe investment was a major contributing factor to the economic crisis that started in 2007.

REAL ESTATE CYCLES

The ups and downs of real estate activities are described as **real estate cycles**. The word *cycle* implies the recurrence of events in a somewhat regular pattern. By studying past real estate market activities, researchers can develop prognoses for future investment plans.

Supply and Demand

Real estate cycles are affected by many variables, all of which, either directly or indirectly, are influenced by the economic forces of supply and demand. Real estate cycles can be short term or long term. In the short-term cycle, the general business conditions that produce the earnings needed to create an effective demand usually trigger the real estate market's activity. In a growth area where business is good and demand is higher than

the available supply of real estate, the prices of properties available for sale increase. This active demand generally encourages more building, and the supply of real estate tends to increase until there is a surplus. When the supply exceeds the demand, prices decrease. Any new construction becomes economically unsound. The cycle repeats itself as soon as the demand again exceeds the supply.

In Practice

An elderly couple lives in a small town. They have decided to sell their home of 34 years and move to a retirement community. Unfortunately, the local factory, the only real business in town, recently closed its doors, putting 300 people out of work. Most of the families who worked there have to relocate as there are no jobs available in the immediate area, even at lower salaries.

Even though the couple isn't directly affected by the factory shutdown, they will suffer the effects of a declining real estate cycle. Their home is now one of many on the market at a time when there are very few potential buyers. The price they will be able to get for their property today is much less than they could have expected a year ago.

Another variable affecting the short-term real estate cycle is the supply of money for financing. Tight money circumstances develop when competitive drains on the money supply occur or the Fed takes certain actions to restrict the supply of money. The two largest competitors for savings are the federal government, with its gargantuan budgetary commitments, and industry, which taps the money markets to finance additional inventory or plant expansion. Any continuing deficits in its budget force the government into the borrowing market, reducing funds available for real estate finance.

In the short term, the market responds to current economic conditions, while in the long term, the time variables associated with real estate development prevail. It takes time to put a real estate project on the ground. From the creation of the idea to the acquisition of the land; through its possible rezoning, engineering, and preparation; during its construction, promotion, and sales, years sometimes pass. During this interval, the markets are fluctuating, and the developer may not achieve the anticipated profit.

Short-term real estate cycles generally run from three to five years. In the long term, they generally run from 10 to 15 years. The ability to examine the causes of the cycles and to forecast their movements in order to anticipate the markets is important to a real estate investor's success.

Population Characteristics

An important factor involved in making real estate development decisions is the makeup of this country's population and how it changes over time. Both financial investors in commercial real estate and real estate professionals in the residential market need to be aware of changing demographics in their local area in order to provide a solid basis for marketing planning. Census information continues to show that the majority of U.S. households live in officially designated metropolitan areas, and mostly in the suburbs.

The number of homeowner households has remained steady since 2007 in the range of 75 million. Single-person households now account for over one-third of the market. The number of rental households increased from 35 million in 2007 to nearly 40 million in 2012. This increase is attributed to two factors: (1) the number of households in foreclosure has forced many into renting, and (2) tightened qualifying standards have made it more difficult to obtain a home mortgage loan. Ironically, the national Housing Affordability Index (a measure of how many households with median income can afford a house of median price) reached an all-time high in 2012; however, the tighter lending standards still made it very difficult to obtain a loan.

Harvard's *State of the Nation's Housing Report 2013* anticipates that in 2015, minorities will make up 36% of U.S. households with 46% in the 25–34 age group. This group represents half of first-time homebuyers. The demographic distribution shows a slight drop in ownership by white persons, with minimal change in ownership by African-Americans, and an increase in ownership by Hispanics and Asian-Americans. The Harvard report estimates growth in the decade of 2015–2025 of between 11 and 13 million, depending on immigration. This would be in line with the annual averages from the 1980s, 1990s, and 2000s.

Who Is Buying What

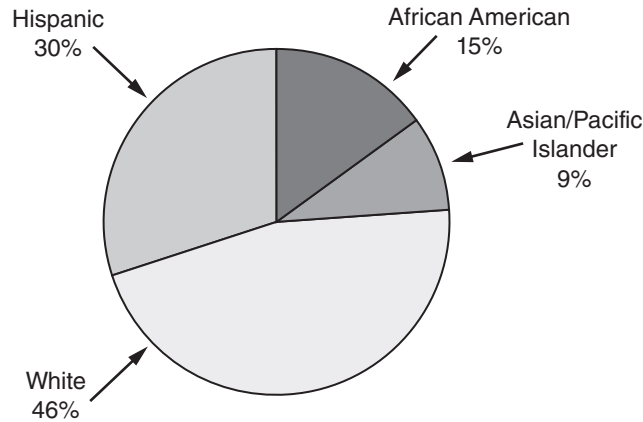
The U.S. Census Bureau description of a median home has enlarged slightly over the last decade and now consists of more than 1,800 square feet (2,200 for new construction) with five or six rooms, three of which are bedrooms. About half have two or more bathrooms. Two-thirds of these households have no children younger than 18. About 30 million persons live alone. The median house value in 2012 was \$181,400. Median household income was \$53,046.

According to the 2013 Census estimate, the population of the United States is 316,128,839. (The census.gov website keeps a daily tally that shows the population as of September 14, 2014, as 318,875,946.) This represents around a 10% increase since 2000. The 2013 population is 50.8% female and 49.2% male, with the rate of growth faster in the older age groups. The median age increased from 35.3 in 2000 to 37.2 in 2010. Maine and Vermont have the highest median age, surpassing the leaders in 2000, which were West Virginia and Florida. Utah remained the state with the lowest median age of 29.2.

A 2004 interim report published by the U.S. Census Bureau projected a new total population in 2050 of 419.854 million, distributed as shown in Figure 1.4. These numbers may all be less, however, as a result of a potential drop in the number of persons immigrating in the next four decades.

Minorities are still expected to make up one-third of the U.S. population by 2016 and were originally expected to account for more than two-thirds of the net increase in households between 2010 and 2020. However, the economic crisis created a decline in the national homeownership rate from a high of 69% in 2004 to 65% in 2014 and also impacted the number of new immigration households. The total number of foreign-born households, which continuously increased in the past, actually started to decline in 2007.

FIGURE 1.4 Projected U.S. Population in 2050



Source: U.S. Census Bureau

An Aging Population

Our population is also aging. The 78 million **baby boomers** born between 1946 and 1964 are creating a middle-aged bulge in population demographics. Unlike the previous generation, boomers are living longer and healthier lives and many continue to work at least part time past the typical retirement age due to the erosion of retirement savings and the loss of acquired home equity. This generation tends to “age in place” and may look to make improvements or modifications in order to remain in their present home or to demand more services and amenities designed for senior citizens in one of the many independent or assisted living options. Harvard’s *State of the Nation’s Housing Report 2013* indicates that the number of households over age 65 will increase by 10.7 million by 2025.

The next age group, those born between 1965 and 1979 and often called **Generation X**, tend to marry later, have a higher divorce rate, and a lower remarriage rate, making the single-person household the fastest-growing household type. According to the Harvard study, persons living alone are expected to account for 36% of household growth between 2010 and 2020.

Then there are the **echo boomers**, those born in the 1980s and early 1990s. There are five million more of them than their parents’ generation. They should be just entering their most productive buying years but are inhibited by current economic conditions, and a large percentage of them continue, or have returned, to live at home. In general, they tend to be interested in green and environmentally friendly types of housing.

The Census Bureau shows our population divided as follows:

- Married couple household: 51.7%
- Two or more people, nonfamily: 6.1%

- Female householder, other family: 12.2%
- Male householder, other family: 4.2%
- Single householder, nonfamily: 25.8%

Social Attitudes

Changing social attitudes also influence real estate cycles. Historically, fast growth was the goal of many U.S. communities, and some still favor this approach today. Local governments often offer concessions to induce industry to move to their towns. Nevertheless, many communities promote an attitude of planned growth, legally limiting new construction activities to satisfy voters' demands.

Throughout the United States, many communities are striving for smart growth, with proper planning a prerequisite for allowing new development. A no-growth policy leads to a downturn in the economy, but rampant overgrowth leaves communities lacking in schools, police and fire protection, and adequate transportation. There is also a growing concern today for energy conservation and other environmental issues.

Tax Issues

The constantly changing federal income tax structure also affects real estate cycles. In 1986, Congress imposed dramatic restrictions on the use of excess losses from real estate investments to shelter other income under the Tax Reform Act of 1986 (TRA '86). Special treatment for capital gains and excessive depreciation deductions were also introduced.

Effective May 7, 1997, Congress again fine-tuned the income tax laws by passing the **Taxpayer Relief Act of 1997 (TRA '97)**, providing homeowners with broad exemptions from capital gains taxes on profits made from the sale of personal residences. Replacing the one-time exemption of \$125,000 for sellers older than age 55, TRA '97 exempts up to \$500,000 of profits from taxes for a married couple filing jointly (or up to \$250,000 for a single person) who have lived in the property as a primary residence for more than two years in the five years previous to the sale.

TRA '97 eliminated the necessity to purchase another residence at a price equal to or higher than that of sold property. It also eliminated keeping records of repairs, additions, or other changes to the sold property's tax basis unless the gain from the sale exceeds the exemptions. These tax benefits may be taken every two years, and Internal Revenue Service (IRS) regulations now stipulate that if the property meets the entire exclusion, the transaction need not be reported at all.

Investors in real estate received additional benefits from TRA '97. The long-term maximum capital gains tax rate was reduced to 15% (5% for investors in the 10% and 15% income brackets). The depreciation recapture tax on the amount that has been depreciated over the years is charged at 25%. Note that the property must be held a minimum of 12 months. In 2001, this rate dropped to 18% (8% for those in the 15% tax bracket) for assets acquired after January 2001 and held for five years or longer.

The reduced 15% tax rate on qualified dividends and long-term capital gains was scheduled to expire in 2008 but was extended through 2010 and again through 2012. From 2008 to 2012, the tax rate was 0% for those in the 10% and 15% tax brackets.

Since 2012, dividends are taxed at the taxpayer's ordinary income tax rate, and the long-term capital gains tax rate is 20% (10% for those in the 15% tax bracket). Also after 2012, the qualified five-year 18% capital gains rate (8% for taxpayers in the 15% tax bracket) was reinstated.

The **Mortgage Forgiveness Debt Relief Act of 2007** provided a benefit for homeowners who had lost a home to foreclosure. In the past, the IRS counted any write-off amount on a loan as taxable income to the borrower. Under this act, any income realized as a result of modification of the terms of the mortgage such as recasting of the loan for a lesser amount, or as a result of foreclosure on a principal residence, was not counted as income. The act was extended through the end of 2013.

American Taxpayer Relief Act of 2012

The **American Taxpayer Relief Act of 2012 (ATRA)** was signed into law on January 2, 2013. The bill extended the mortgage debt cancellation relief that had been granted under the Mortgage Forgiveness Debt Relief Act of 2007 through 2013. The act also extended the deduction for mortgage insurance premiums for tax filers making less than \$110,000. Both of these extensions expired January 1, 2014, and remain in congressional limbo. It has been suggested that the slight drop in the number of short sales in 2014 may be due to the uncertainty over the debt relief. Another extension awaiting further action is the 10% tax credit, up to \$500, for homeowners making energy efficient improvements to an existing home.

Current tax rates were extended for households earning less than \$450,000 or \$400,000 for individual filers. For households earning more than these limits, tax rates reverted to 2003 numbers, resulting in taxpayers in the highest income bracket paying at a rate of 39.5%, up from 35%.

The tax rate on capital gains remains the same, at 15%, for most households, with an increase to 20% for the higher income bracket. The exclusion from taxes for gains on a principal residence remains the same unless the sellers are in the higher income bracket.

A key change in estate tax is the requirement that estates be taxed at a top rate of 40%, with the first \$5 million in value exempted for individual estates and \$10 million for family estates.

For more information, see the IRS website at www.irs.gov.

Property Value Fluctuations

Although some properties display a character of their own and run counter to prevailing trends, most properties are carried along in a cyclical action. Generally, in the long run, most real property values rise. In the short run, property values rise and fall.

In the past, the stabilizing influences of Fannie Mae, Freddie Mac, and Ginnie Mae calmed some of the volatile short-term reactions of localized booms and busts. At the same time, the financial management policies of the Federal Reserve and the U.S. Treasury largely soothed long-term reactions to these cycles. These latter federal government agencies were expected to control the supply of money in circulation. The financial crisis that began in 2007 challenged every aspect of mortgage financing, from the federal government to the local bank on the corner.

Traditional real estate cycles can be moderated by better market information and by increasing openness about real estate dealings, financing, and new construction. The following four key groups are largely responsible for providing this important market information:

- Bond analysts and rating agencies submit highly detailed information to investors who participate in mortgage-backed securities.
- Real estate investment trust (REIT) analysts provide full disclosure of the data in the field that now controls a substantial percentage of the commercial real estate market.
- Bank and insurance analysts publish essential underwriting market data.
- Information providers on the internet act as important sources of the vast amount of data available.

IMPACT OF THE FINANCIAL CRISIS

After years of spectacular growth in the single-family housing market with concomitant increases in property values, the housing market boom came to an abrupt halt in mid-2008. Upon the discovery that lenders all over the country had issued thousands of subprime loans to unqualified borrowers on properties with super-inflated values, the financial markets froze and stopped making loans.

Even Fannie Mae and Freddie Mac were caught up in the lending disaster, having purchased thousands of “worthless” loans that they bundled and sold to international investors. The federal government stepped in to rescue these government-sponsored enterprises from bankruptcy, confiscating their assets and firing managers.

Now in conservatorship under the Federal Housing Finance Agency (FHFA), Fannie Mae and Freddie Mac have reinstated their basic standards, which real estate lenders must carefully observe if they wish to sell their new loans to these secondary market operators. The tighter qualifying standards have driven many potential borrowers to government-owned or guaranteed loans. FHA became the primary lender for low down payment loans, accounting for 80% of the market in 2012. USDA Section 502 guarantees for homes in rural areas also increased significantly. In 2014, a new cycle may be starting as more private investment returns to the real estate financing market. The percentage of conventional loans sold to Fannie Mae and Freddie Mac continues to rise, and the percentage of FHA loans is decreasing slightly. Discussion continues on the future of Fannie Mae and Freddie Mac, but the FHFA expects business as usual for at least a few more years.

SUMMARY

Millions of persons are involved in some form of activity related to real estate. When flourishing, the construction industry directly employs millions of people. Innumerable

additional workers are engaged in providing this industry its materials and peripheral services.

Most real estate activities are financed. Monies accumulated by thrifts, banks, life insurance companies, pension funds, and other formal financial intermediaries are loaned to builders and developers to finance their projects. Other loans are made to buyers of already existing structures, providing the financial institutions a continuing opportunity for investments of their entrusted funds. These investments produce returns and new funds available for loans to stimulate additional growth.

These financing activities are based on the simple premise of real estate being pledged as collateral to guarantee the repayment of a loan. An owner of a property borrows money from a lender and executes a promise to repay this loan under agreed-upon terms and conditions. The real estate is pledged as collateral to back up this promise. The borrower continues to be able to possess and use the collateral real estate during the term of the loan. The ability to maintain control of the property while borrowing against it is called hypothecation. It is also a manifestation of leverage, by which a small amount of money can provide the means for securing a large loan for the purchase of property. If the promise to repay the loan is broken, the lender can acquire the collateral and sell it to recover the investment.

Generally, the majority of loans on real estate are made by local financing institutions, using deposits accumulated by persons in the community. However, a national market for real estate finance operates under the auspices of Fannie Mae, Freddie Mac, Ginnie Mae, the Federal Home Loan Bank, and private investors. These agencies provide a secondary market for buying and selling mortgages on a national level.

The overall cycle of real estate economics and finance is modified by the forces of supply and demand. Excess demand normally leads to increased production until excess supply reverses the cycle. Mirroring these forces of supply and demand is the availability of money for financing at reasonable costs. Other variables that affect real estate cycles include population changes in terms of numbers, age, and social attitudes; changes in political attitudes governing community growth policies; and changes in the federal income tax structure.

Complementing the secondary market activities that balance national level mortgage loan funding sources are the much broader controls exercised by the Federal Reserve (the Fed) and the U.S. Treasury. By controlling the amounts of money in circulation and the cost of securing mortgage funds, these agencies attempt to balance the fluctuations of the national money market.

The general decline in the housing market in 2006 started the domino effect of people unable to sell or refinance their homes and going into foreclosure. Purchases of packages of “junk” loans led to further financial collapse on the secondary market. Hopefully, the housing market will be able to lead the road to economic recovery over the next decade.

INTERNET RESOURCES

Fannie Mae
www.fanniemae.com

Federal Housing Finance Agency
www.fhfa.gov

Freddie Mac
www.freddiemac.com

Ginnie Mae
www.ginniemae.gov

Joint Center for Housing Studies of Harvard University
www.jchs.harvard.edu

Internal Revenue Service
www.irs.gov

RealtyTrac®
www.realtytrac.com

U.S. Census Bureau
www.census.gov

REVIEW QUESTIONS

1. This country's economic well-being would be substantially affected by a slowdown in which industry?
 - a. Farm
 - b. Steel
 - c. Construction
 - d. Garment
2. A financial institution experiencing disintermediation is *BEST* described as
 - a. a form of dispute resolution.
 - b. more funds being withdrawn than deposited.
 - c. an involuntary stock takeover.
 - d. an excess of subprime loans.
3. A situation where the borrower retains possession of the property while the lender has a security interest is called
 - a. disintermediation.
 - b. collateral.
 - c. hypothecation.
 - d. leverage.
4. A buyer makes a very small down payment and borrows the balance needed to purchase real property. This is called using
 - a. leverage.
 - b. collateral.
 - c. hypothecation.
 - d. equitable title.
5. The largest holder of mortgage loan debt for one-to four-family units are
 - a. major financial institutions.
 - b. mortgage pools and trusts.
 - c. individuals and others.
 - d. federal and related agencies.
6. Which activity would have the *MOST* effect on property values in a moderately sized Midwestern city?
 - a. Crash of the Japanese stock market
 - b. Decline in the NASDAQ stock exchange
 - c. Closing of the largest factory in the city
 - d. Extensive hurricane damage in the South
7. According to the U.S. Census Bureau, the largest percentage of households today are
 - a. married couples.
 - b. female heads of household.
 - c. two unrelated persons.
 - d. single people.
8. A city is experiencing 28% growth in population this year as a result of three new industries moving into the area. Based on supply and demand, this population growth will probably lead to
 - a. a decline in home prices.
 - b. an increase in home prices.
 - c. an increase in property taxes.
 - d. a decrease in property taxes.
9. The population demographics of the United States are changing in all categories *EXCEPT*
 - a. an increase in Asian and Hispanic households.
 - b. baby boomers reaching middle age.
 - c. an increase in number of elderly households.
 - d. a higher birth rate.
10. In order to qualify for the \$500,000 exemption from capital gains tax on the sale of their home, a couple must have
 - a. lived there the two years prior to selling.
 - b. lived there an aggregate of two years out of the past five years.
 - c. lived there two years plus be at least 55 years old.
 - d. never used the residence as a rental property.

Money and the Monetary System

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- describe the activities of the Federal Reserve System;
- explain the role of the U.S. Department of the Treasury as the nation's fiscal manager;
- discuss the role of the Federal Home Loan Bank System (FHLB); and
- outline the responsibilities of the Federal Deposit Insurance Corporation (FDIC).

annual percentage rate (APR)

commercial paper

discount rate

Federal Deposit Insurance Corporation (FDIC)

federal funds rate

M1, M2, M3

open-market operations

prime rate

quantitative easing (QE)

Regulation Z

reserve requirements

securities

Treasury bonds

Treasury bills

Treasury notes

Troubled Asset Relief Program (TARP)

Truth in Lending Act (TILA)

An understanding of mortgage lending requires knowledge of how the mortgage market functions within our monetary system. The federal government is deeply involved in our financial systems, beginning with the creation and distribution of money. The government also provides a number of regulatory agencies to supervise the actions of financial institutions and their representatives to insure and protect a multitude of depositors. The federal participants in the monetary system, which

control to a great degree the activities in the real estate financial markets, are the Federal Reserve (the Fed), the U.S. Treasury, and the Federal Home Loan Bank (FHLB) System. These agencies will be reviewed in this chapter, as will the **Federal Deposit Insurance Corporation (FDIC)**.

WHAT IS MONEY?

Definition

Money allows us to convert our physical and mental efforts into a convenient method of exchange. Thus, we can define money as

- a medium of exchange or means of payment,
- a storehouse of purchasing power, and/or
- a standard of value.

In primitive societies, money is anything that is generally accepted as a means of exchange, such as beads, salt, shells, and so on. Money can also be represented by coins, bills, or checks, which are currently our convenient, acceptable, representative means for exchanging value.

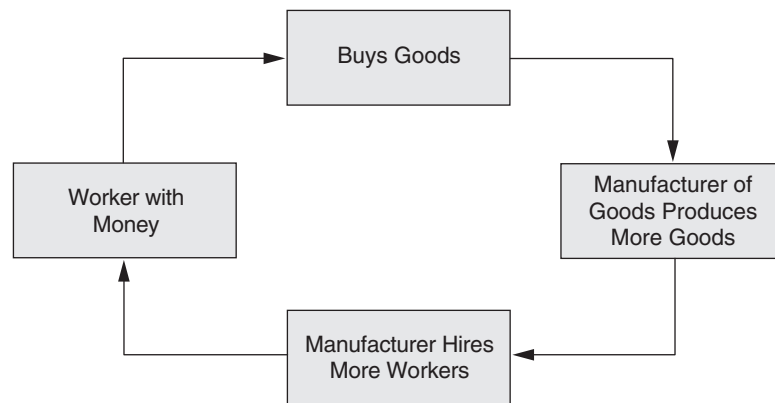
Today's system of money is based on confidence. As long as the public can exchange symbolic paper money for commodities of like value, the system works. When that confidence is shaken, as in countries suffering economic or political turmoil, the ability of money to command commodities of like value diminishes.

Most people strive to acquire money for the goods and services it can purchase. Our efforts to acquire money are related directly to satisfying our need for food, clothing, and shelter. After we have acquired these essentials, we strive to accumulate money to satisfy our need for additional security, pleasure, or power, depending on individual motivations.

The Supply and Costs of Money

Economic stability is linked directly to the supply of money and the cost of money. As shown in Figure 2.1, the larger the supply of money in circulation, the greater the economic activity. When the economy is infused with more spendable cash, the possibility for an increase in spending activity is enhanced. Increased spending requires increased production to replenish depleted inventories. With increased production come more jobs; more people are employed and are spending money.

FIGURE 2.1 The Supply of Money and Economic Activity



If this economic cycle is true, then the reverse condition, the withdrawal of funds from circulation, should result in a slowdown of economic activity.

The three measures of the total money supply are known as the monetary aggregates of M1, M2, and M3. The M stands for money, and the numbers represent increasing levels of liquidity.

- **M1** is money easily obtainable: cash in public hands, private checking accounts at commercial banks, credit union share accounts, and demand deposits at thrift institutions. (The amount of money held by the Federal Reserve is subtracted from this amount.)
- **M2** is assets less liquid: all of M1 plus money market funds (except those in IRAs or Keogh accounts), retirement accounts, and deposits of less than \$100,000.
- **M3** is assets even less liquid: all of M2 plus deposits over \$100,000, money held in banks abroad, institutional money market funds (including pension fund deposits), and deposits with non-bank institutions. (The Federal Reserve no longer makes data on M3 available to the public.)

Considering the cost of money in terms of the interest charged for borrowed funds, it would appear that the higher the cost, the lower the borrowing activity and the slower the economic activity. The reverse situation, the lowering of interest rates, should raise the demand for borrowed funds and produce increased economic activity.

Theoretically, then, manipulations of the supply and cost of money should result in economic balance. The reality is that a balanced economy is largely shaped by the federal agencies empowered to control the supply and cost of money (e.g., the Federal Reserve System, the U.S. Treasury, and the Federal Home Loan Bank System). Although their efforts at balancing the national economy are not always successful, resulting in part from time lags and consumer resistance, these agencies have a profound effect on national real estate finance.

THE FEDERAL RESERVE SYSTEM (THE FED)

The Federal Reserve System (the Fed) is this nation's monetary manager. The Fed is charged with the maintenance of sound credit conditions to help counteract inflationary and deflationary movements. It also has a role in creating conditions favorable to high employment, stable values, internal growth of the nation, and rising levels of consumption. The Fed keeps the public informed of its activities through its website at www.federalreserve.gov. The website includes many topics, such as a survey of consumer finances, statistical releases on a variety of subjects including household finance, and reports from meetings of the Federal Advisory Council and Board of Governors.

Purpose

The Fed was established in 1913 when President Woodrow Wilson signed the Federal Reserve Act. This act's original purpose was to establish facilities for selling or discounting commercial paper and to improve the supervision of banking activities. Its full impact on our monetary system has broadened over time to include influence over the availability and cost of money and credit (interest rates).

As the central bank of the United States, the Fed attempts to ensure that money and credit growth over the long run is sufficient to provide a rising standard of living for all U.S. citizens. In the short run, the Fed seeks to adapt its policies in an effort to combat deflationary or inflationary pressures; as a lender of last resort, it has the responsibility of using policy instruments available to it in an attempt to forestall national liquidity crises and financial panics.

In response to the financial crisis that emerged in the summer of 2007, the Fed used special programs designed to address severe liquidity strains in key financial markets, to provide credit to troubled important institutions, and to lower longer-term interest rates. An important first step was the lowering of the target federal funds rate from 5¼% to effectively zero. On September 13, 2012, the Fed announced that it would keep that rate at zero until 2015 and below 2% into 2016. Other programs were initiated to support the liquidity of financial institutions and to create improved conditions in financial markets. The Fed expanded its traditional tool of open market operations by purchasing long-term securities, such as agency-guaranteed, mortgage-backed securities (MBS) and long-term (10-year) Treasury notes. This program was referred to as **quantitative easing (QE)** and was planned to continue until unemployment fell below 6.5% or inflation rose above 2.5%. From 2008 to 2011, the Fed spent more than \$2 trillion in the purchase of bank and government debt. It also committed to trillions more in insuring and loaning money to banks for money market funds and to purchase commercial paper. By mid-2014, the goals of the QE program were close to being realized. On October 29, 2014, the Fed announced it would no longer purchase bonds and ended the program. As long as the bonds already purchased remain with the Fed, the interest rates should remain low.

Under the Dodd-Frank Act that was signed on July 21, 2010, the Fed assumed new regulatory powers. In addition to supervising approximately 3,000 member banks, the Fed is also responsible for approximately 17,000 other depository institutions, including nonmember commercial banks, savings banks, savings and loan associations, and credit unions. Although not formally part of the Federal Reserve System, these institutions are

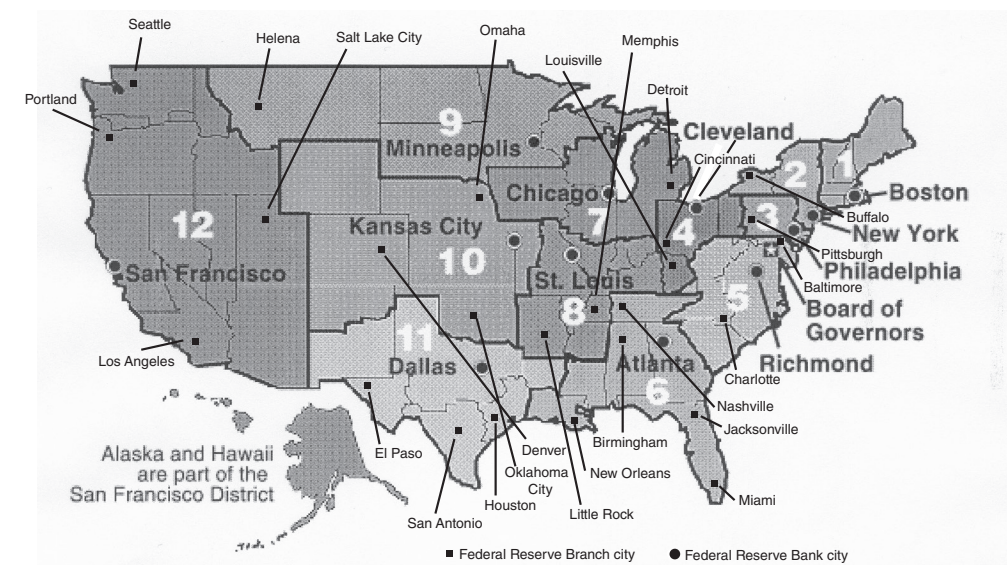
subject to system regulations, including reserve requirements, and they have access to system payment services. The Fed also houses the Consumer Financial Protection Bureau. The act limits the Fed's emergency lending authority by requiring approval from the Secretary of the Treasury for any lending program.

Organization

The Fed is a central banking system composed of 12 Federal Reserve districts. Each is served by a district Federal Reserve Bank, coordinated and directed by a single seven-member board of governors housed in Washington, DC. These districts and their branch territories are shown in Figure 2.2.

The Federal Reserve banks are not under the control of any governmental agency, but each reserve bank is responsible to a board of directors. Each board is composed of nine members representing their Federal Reserve district. The organization of the Fed is shown in Figure 2.3. Members are drawn from the 12 districts to form three statutory advisory councils that advise the board on matters of current interest: the Federal Advisory Council, the Consumer Advisory Council, and the Thrift Institutions Advisory Council.

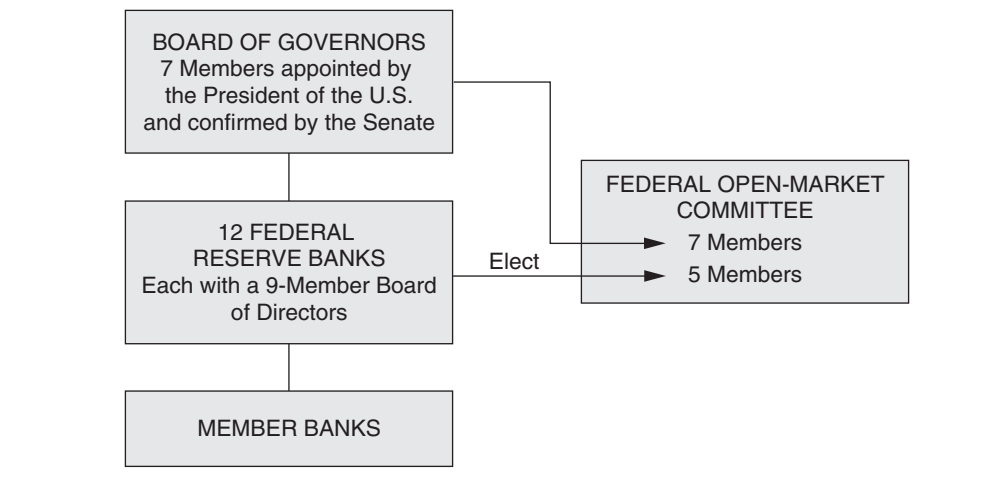
FIGURE 2.2 The Federal Reserve System (Boundaries of Federal Reserve Districts and Their Branch Territories)



Member Banks

All nationally chartered commercial banks must join the Fed while state-chartered banks may also become members of the system. Each member bank is required to purchase capital stock in its Federal Reserve district bank to maintain sufficient monetary reserves to meet the Fed's requirements and to clear checks through the system. In addition, they must comply with other rules and regulations imposed by the Fed for governing loans made by member banks and maintaining the stability of our monetary system by insuring

FIGURE 2.3 Organization of the Federal Reserve System



their deposits. Member banks may borrow money from their federal district bank when in need of funds, share in the informational systems available, and generally engage in all banking activities under the protective umbrella of the Fed.

INSTRUMENTS OF CREDIT POLICY

The Fed has numerous functions, among which are issuing currency in the form of Federal Reserve notes (paper money), supervising and regulating member banks, clearing and collecting their checks, and administering selective credit controls over other segments of the economy. Other functions include acting as the government's fiscal agent in holding the U.S. Treasury's principal checking accounts and assisting in the collection and distribution of income taxes. However, the four functions most closely related to real estate finance are

- the Fed's regulation of the amount of its member banks' reserves,
- determination of the discount rates,
- open-market operations, and
- supervision of the Truth in Lending Act (Regulation Z).

Reserve Requirements

Each of the Fed's individual member banks is required to keep reserves equal to a specified percentage of the bank's total funds on deposit with its federal district bank. These **reserve requirements** are designed to protect bank depositors by guaranteeing that their funds will be available when they need them. More important, though, is the Fed's ability to manage the national money market by adjusting the amount of reserves required from time to time. By raising the reserve requirement (and thereby limiting the amount of money available to the member banks for making loans), the Fed can frequently cool

down a hot money market and slow the economic pace. By lowering the reserve requirements, the Fed can permit more money to enter a sluggish economy. Member banks can retain a larger percentage of their total assets, allowing more money to become available for loans. Managing the reserve requirements is one way the Fed serves its purpose of balancing the national economy.

In Practice

What would happen if figures were released showing almost a 2% increase in inflation for the quarter plus a sharp drop in unemployment? Although this might seem more like good news than bad news, this combination would be a matter of concern to the Fed. The Fed is responsible for maintaining a stable economy and, ironically, the Fed must be as concerned when things are going too well as when things seem to be slowing down. The Fed must take quick action to prevent a spiraling effect into a run-away economy. If unemployment is low, employment is high. In order to attract good employees from a shrinking pool of job seekers, a company may have to pay higher salaries. In order to pay the higher salaries, the company raises prices. Higher prices lead to inflation.

The Fed has several tools it may use to slow things down, but the most likely one in this situation would be an announcement that the federal discount rate will be increased. The discount rate is the interest charged by the Fed to its member banks. When this rate is increased, even if only by a quarter of a percent, there is usually an immediate reaction in the financial world. A slight “tap on the brakes” by the Fed can slow down the acceleration, heading off more serious problems later. Sometimes just a casual hint from the Fed’s chairperson that rates may be going up will achieve the desired effect.

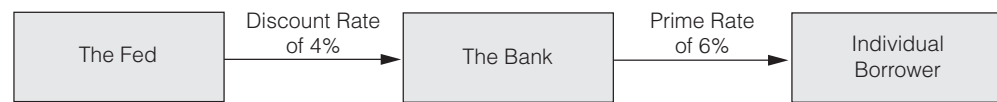
The amounts of reserves vary from 3 to 22% of the member banks’ funds, depending on the type of these deposits and the location of the member banks (since 2008, the reserve rate has remained low). For instance, more reserves are required for checking accounts than for savings deposits, reflecting the short-term quality of the former versus the long-term quality of the latter. In addition, more reserves are required from a city bank than a country bank because of the increased banking activities expected from numerous urban depositors as opposed to a smaller number of rural depositors.

Discount Rates

Commercial banks operate primarily to finance personal property purchases and short-term business needs. The loans they issue are called **commercial paper**. The Fed operates a market for selling this paper at a discount, providing member banks with additional funds for continued lending activity. This is done at the “discount window,” which is either open or closed to control the money supply. When the window is open, money is added to the system, and vice versa.

Although discounting commercial paper may appear to have little significance for real estate finance, the process enables members to expand their lending activities. The banks actually borrow funds from their district federal reserve bank and pledge their commer-

FIGURE 2.4 Discount and Prime Rates



cial paper as collateral. In effect, the Fed charges the borrowing bank interest on its loan, interest that is considered to be the **discount rate**, which can also be interpreted as the cost of borrowed funds to the borrower bank. Thus, the individual bank has a basic or primary interest rate against which it can measure the interest it must charge its borrowers. As illustrated in Figure 2.4, the Fed discount rate is used by many major banks to set their **prime rate**, prime simply meaning the rate a commercial bank charges its most creditworthy customers or its prime customers. Now the implications for real estate finance become clearer. The higher the Fed's discount rate charged to the bank, the higher its prime will be, and, consequently, the higher the rate of interest to the real estate borrower.

In mortgage lending, these discounts establish the base interest charges for short-term mortgage loans. Borrowers, depending on their credit standings, can expect to pay the prime rate or higher, as circumstances dictate. For example, many construction loans are secured from commercial banks at “two points above prime,” or 2% above the prime rate. If the prime rate is 6% when the construction loan is made, the interest rate charged under this formula would be 8%. Thus, by adjusting the rate of its discount, the Fed exerts a great deal of control over the amount of money or credit available throughout the system.

When the Fed raises its discount rate, member banks slow their sales of commercial paper and obtain fewer additional funds. Therefore, less credit becomes available at the local level, and, theoretically, the economy is slowed. Of course, the reverse process occurs when the discount rate is lowered. The Fed's discount rate can be found daily in the *Wall Street Journal* and other financial publications.

Federal Funds Rate

The Fed also lends money to its member banks without requiring any collateral. These loans are usually made for short periods of time, and the rate of interest that is charged to the borrowing banks is known as the **federal funds rate**. It is the rate that banks charge each other for short-term funding, often overnight loans. The banks use this interbank borrowing to meet the Fed's requirements for cash liquidity in the bank's portfolio. The federal funds rate is published daily in financial journals and becomes another benchmark against which the banks can base interest charges to their customers.

Open-Market Operations

The Fed relies on its **open-market operations** as another important tool to achieve its goal of balancing the economy. These activities involve the purchase or sale of government securities in lots, which consist primarily of U.S. Treasury issues, and also include securities issued by the federally sponsored housing and farm credit agencies, the Federal Home Loan Bank system, the Federal Housing Administration (FHA), Ginnie Mae, and others.

Open-market bulk trading in securities generally averages several billion dollars per day. Special dealers authorized to handle these transactions over the counter manage the purchase and sale of these securities. Dealers and their customers are linked by a national communication system of services that facilitate the transfer of tremendous quantities of securities.

The Fed's open-market operations are directed and regulated by the system's Federal Open-Market Committee (FOMC), which meets monthly to decide on current policies. This committee is composed of 12 members. All seven members of the Federal Reserve's board of governors serve on FOMC, giving them the majority. The president of the Federal Reserve Bank of New York and four other district reserve bank presidents are elected to serve one-year terms on a rotating basis.

A decision by FOMC to buy or sell securities has an immediate and important impact on the availability of money for economic activities. When FOMC sells securities, the economy slows down, as money available for credit is withdrawn from the market. When FOMC buys securities, it is in effect pumping money into the economic system, thereby encouraging growth and expansion. The impact of these procedures on the availability of money for real estate is quite similar to the impact caused by raising or lowering the discount rate.

Truth in Lending Act (TILA, Regulation Z)

The Federal Reserve is responsible for supervising the **Truth in Lending Act (TILA)**, Title I of the Consumer Protection Act of 1968. The Fed's board of governors was given the responsibility at that time to formulate and issue a regulation, called **Regulation Z**, to carry out the purposes of this act. Rulemaking authority for TILA regulations was transferred to the Consumer Financial Protection Bureau (CFPB) on July 21, 2011, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The exemption threshold was raised from \$25,000 to \$50,000 and is to be adjusted annually based on the percentage increase in the Consumer Price Index. The threshold as of January 1, 2015, will be \$54,600.

Each of the following three loan types is covered by the act if the loan is to be repaid in more than four installments or if a finance charge is made:

- Real estate loans
- Loans for personal, family, or household purposes
- Consumer loans for \$50,000 or less

In the final analysis, however, Regulation Z is nothing more than a law requiring that lenders reveal total loan costs through the use of a standard measurement of interest rates, called an **annual percentage rate (APR)**. This is not an interest rate per se, but simply a rate that will reflect the effective rate of interest on a loan.

■ **FOR EXAMPLE** Assume a borrower needs \$1,000 for one year at 8% interest. If, at the end of the year, the borrower repays the \$1,000 plus the \$80 interest, the annual percentage rate (APR) and the interest rate will be the same ($\$80 \div \$1,000 = 8\%$). However, if the lender collected a \$25 service charge in advance, the borrower would receive

\$975 instead of \$1,000 and pay \$105 instead of \$80. The APR would be calculated as follows: $\$105 \div \$975 = 10.77\%$.

In addition to the finance charge and the APR, the Regulation Z disclosure statement must include the creditor's identity; the amount financed; the number, amount, and due dates of the payments; the notice of the right to receive an itemization of the amount financed; the late payment and prepayment provisions and penalties; a description of the security; and whether the loan can be assumed by a subsequent purchaser.

The CFPB was charged with developing a form that combined the disclosures required by the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z). After a lengthy study period, the two new integrated mortgage disclosure forms will go into effect on August 1, 2015. The Loan Estimate will replace both the RESPA and the TILA disclosure forms. The Closing Disclosure form will replace the HUD-1 Settlement Statement.

Advertising

Prior to the passage of the Truth in Lending Act, residential real estate lenders and arrangers of credit frequently included only the favorable loan aspects in advertisements, thus distorting the actual cost of obtaining credit. Now, advertising is strictly regulated by the law, and advertisers are required to disclose all financing details if any one item is disclosed. The advertising requirements apply to television, handbills, signs, and, as shown in Figure 2.5, newspapers.

Advertising terms that would require complete disclosure include "Only 5% down!"; "Why pay the landlord when you can own for \$550 per month?"; "30-year financing available"; or "Assume a 9.5% VA loan." Advertising terms that would not require complete disclosure include "Low down payment"; "Easy monthly payments"; "10% APR loans available"; or "FHA and VA loans."

Right of Rescission

Under Regulation Z, if a consumer obtains a loan (refinancing, remodeling, or equity) that is secured by a principal residence, the borrower has the right to rescind the transaction up to three business days following the loan application or delivery of the disclosure statement, whichever comes later. Because borrowers have the three-day rescission period, lenders usually do not release funds until the rescission period has passed.

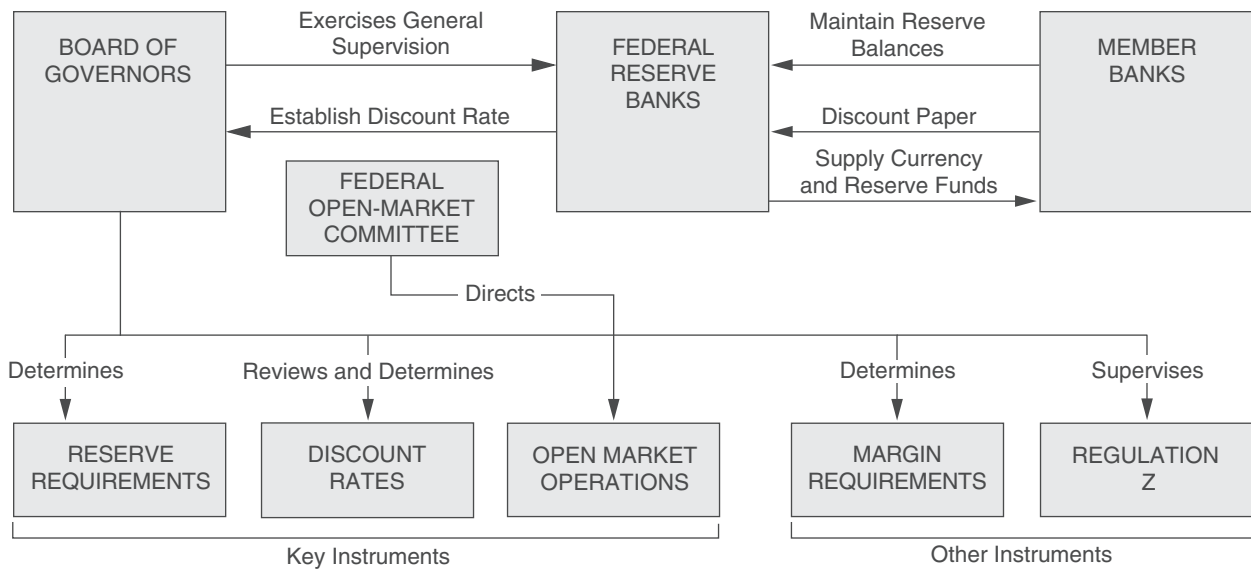
A major exception to the right of rescission applies to a loan that is used for the purchase or initial construction of the borrower's principal residence. Consequently, there is no right of rescission in a typical residential real estate purchase.

Any lender or arranger of credit who intentionally violates the requirements of the Truth in Lending Act is subject to a fine of up to \$5,000 and/or imprisonment for up to one year. However, if the lender or arranger of credit unintentionally violates the law, the lender or arranger could be liable to the borrower for actual and punitive damages equal to twice the finance charge, up to a maximum of \$1,000. A summary of the Fed's credit policy tools is shown in Figure 2.6.

FIGURE 2.5 Newspaper Advertisement



FIGURE 2.6 Relation to Credit Policy Tools of the Federal Reserve System



Source: Federal Reserve Board

THE U.S. TREASURY

Although the Fed regulates money and credit, the U.S. Treasury is also involved in maintaining the nation's economic balance. The Fed may be called the nation's monetary manager. The Treasury serves as the nation's fiscal manager and is self-described as "the steward of U.S. economic and financial systems" (see www.treasury.gov/about/role-of-treasury/). The Department of the Treasury is responsible for advising the president on economic and financial matters, encouraging economic growth within the country, and improving governance in financial institutions. The Secretary of the Treasury has played a significant role in working towards a resolution of the economic crisis starting in 2007. How effectively the Treasury balances the government's income against its long-term and short-term debt instruments has a direct effect on the monetary and credit climate of the country.

The basic functions of the Department of the Treasury include

- collecting taxes, duties, and monies paid to and due to the United States;
- paying all bills of the United States;
- producing currency and coinage;
- supervising national banks and thrift institutions;
- enforcing federal finance and tax laws; and
- investigating and prosecuting tax evaders, counterfeiters, and forgers.

Under 2008's **Troubled Asset Relief Program (TARP)**, the Treasury was authorized to spend \$700 billion to purchase assets and equity from financial institutions in trouble with a cost to the taxpayers of as much as \$300 billion. In March 2011, the Congressional Budget Office stated that the actual expenditure would be \$432 billion at a cost of \$19 billion to taxpayers. The authority to make new financial commitments under TARP ended on October 3, 2010. As of July 31, 2014, cumulative collections under TARP, together with the Treasury's additional proceeds from the sale of non-TARP shares of AIG, exceed total disbursements by \$15 billion. The Treasury is now winding down its remaining TARP investments and is also continuing to implement TARP initiatives to help struggling homeowners avoid foreclosure.

The Nation's Fiscal Manager

The Treasury collects funds for government operating expenses from federal income tax payments, Social Security receipts, and other sources. These receipts are held on deposit in Federal Reserve banks and other insured domestic and foreign banks. Employers regularly send their payroll deductions for income tax and Social Security withholding tax to the nearest federal bank.

When federal revenues do not keep pace with federal spending, in either volume or timing, a deficit occurs. Often the amount of government funds on deposit in the nation's banks is not sufficient to make the payments required to keep the ongoing federal agencies in operation. The Treasury then has to borrow money to offset these shortages.

From time to time, short-term or long-term debt instruments, called **securities**, may be issued and sold by the Treasury to generate the cash it requires. These securities are guaranteed by the full faith and credit of the U.S. government, whose financial stability is backed by its taxing power. It is not so much the total amount of the national debt that is the measure of our economic health as it is the willingness of our citizens to pay for it by buying government security issues.

The national debt is composed of smaller component debts of varying denominations, drawn at different interest rates and due at various times. The Treasury's long-term debt instruments, called **Treasury bonds**, mature in 30 years; its intermediate-length obligations, for two to ten years, are called **Treasury notes**; and its short-term securities are called **Treasury bills**. As existing debt instruments become due, they are either repaid, reducing the balance of the overall debt, or refinanced by a new issue of bonds, notes, and/or bills. At the same time, Treasury officials must meet their continuing regular fiscal obligations, which include federal payrolls and Social Security payments.

The Treasury's Role

The Treasury mixes its issues of short-term and long-term debt instruments to repay or refinance the securities periodically coming due. How it keeps the government in funds directly influences the money supply and indirectly affects sources of funds for real estate finance. Theoretically, issuing more securities should remove money from a "hot" economy and act to slow it down, just like the selling operations for FOMC. Likewise, repaying some securities issues as they become due should pump more money into a sagging economy.

Sometimes, because of purely fiscal pressure, the Treasury's efforts run counter to the Fed's goals. For instance, in an attempt to speed up a sluggish economy, the Fed will reduce its reserve requirements and discount rates to pump money into the economy. Simultaneously, the Treasury will float a huge securities issue to meet unusually large deficits. By removing funds from the market, the Treasury is counteracting the Fed.

Historically, the Treasury has assumed a continuing role as supplier of funds for practically all federal agencies. This role makes the Treasury a primary contributor to the success of many important national programs for real estate financing. The Treasury's participation in establishing Fannie Mae and Ginnie Mae created a national secondary mortgage market. The Treasury's funding of the federal land bank system has been of immeasurable and sustained help to farmers.

Due to the economic crisis, the U.S. Treasury added \$200 billion to its commitment for Fannie Mae and Freddie Mac. The Treasury continues to work with the Fed and the FDIC to assist in the recovery of the U.S. financial system.

Further discussion of the various roles of the Treasury Department may be explored on www.treasury.gov.

Office of the Comptroller of the Currency (OCC)

An important bureau of the U.S. Department of the Treasury is the Office of the Comptroller of the Currency (OCC). It was organized in 1863 in large part to establish a national currency to finance the Civil War. The current role of the OCC is to charter,

regulate, and supervise all national banks. In regulating national banks and federal thrifts, the OCC has the power to

1. examine the national banks and thrifts;
2. approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure;
3. take supervisory actions against national banks and federal thrifts that do not comply with laws and regulations or otherwise engage in unsound practices (possible actions include removing officers and directors, negotiating agreements to change banking practices, and issuing cease and desist orders as civil money penalties); and
4. issue rules and regulations, legal interpretations, and corporate decisions governing investments, lending, and other practices.

Its operations are funded primarily by assessments on the national banks with additional revenue from investment in U.S. Treasury securities. See www.occ.treas.gov for more information.

Office of Thrift Supervision (OTS)

Similarly, the Office of Thrift Supervision (OTS) was created to charter, regulate, and supervise the nation's thrift (savings) associations. Many of the new charters approved by OTS were issued to nonbanks such as insurance companies and other large financial entities. A federal charter from the OTS preempted state laws and allowed banking operations in all 50 states. On July 21, 2011, as part of the Dodd-Frank Act, the OTS was merged with the Office of the Comptroller of the Currency. The OCC now regulates both national banks and federal savings associations (thrifts).

The Bureau of Engraving and Printing

The **Bureau of Engraving and Printing (BEP)** is also part of the Department of Treasury. The bureau produces security documents along with billions of Federal Reserve notes for delivery to the Federal Reserve System each year. These notes are produced at facilities in Washington, DC, and Fort Worth, Texas. Over the past few years, the bureau has worked on a program to redesign Federal Reserve notes in an effort to discourage counterfeiting, and several new bills have been created. The most recent is the \$100 bill that features the 3-D security ribbon and the bell in the inkwell.

In addition to U.S. currency, the BEP also produces portions of U.S. passports, materials for Homeland Security, military identification cards, and Immigration and Naturalization Certificates.

THE U.S. MINT

Congress created the **U.S. Mint** in 1792. Its primary mission is to produce an adequate volume of circulatory coinage for the nation to conduct its trade and commerce. Its recent

activities include producing up to 20 billion coins annually in addition to maintaining physical custody and protection of the nation's billions of dollars of gold and silver assets.

The Mint also produces commemorative coins and medals for the general public as well as selling platinum, gold, and silver bullion coins. It has production and storage facilities in Denver, Philadelphia, San Francisco, West Point, and Fort Knox.

THE FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

The Federal Deposit Insurance Corporation (FDIC) was created as an independent agency in 1933 in response to the thousands of bank failures that occurred during the Great Depression. Initially, bank deposits were insured up to \$5,000 for each account. This coverage climbed steadily over the years to its present level of \$250,000 per title per account. The FDIC insures all accounts in member depository institutions, both banks and savings associations (thrifts). Since the beginning of the FDIC program, no depositor has lost any money due to a bank failure.

The FDIC receives no Congressional appropriations. It is funded by premiums that are paid by banks and thrifts and from earnings from U.S. Treasury securities. As of 2014, the FDIC insures more than \$7 trillion of deposits in virtually every bank and thrift in the country. FDIC does not insure securities, mutual funds, stocks, bonds, or insurance or annuity products.

The FDIC is managed by a five-person board of directors appointed by the President of the United States with senate approval, with no more than three from the same political party. The FDIC regularly examines and supervises more than half of the institutions in the banking system for operational safety and soundness. The banks are also examined for compliance with consumer protection laws like the Fair Credit Reporting Act, Fair Debt Collection Practices Act, and Community Reinvestment Act (CRA).

The FDIC responds immediately when a bank or thrift fails. The institution is usually closed by its chartering authority, which is the state or the OOC (or the OTS until it was transferred to the OCC). The two most common methods employed by the FDIC in cases of insolvency or illiquidity are the following:

- Purchase and Assumption Method—all deposits are assumed by an open bank. That bank may purchase the failed bank's assets or they may be auctioned online.
- Payout Method—insured deposits are paid by the FDIC, which attempts to recover the funds by liquidating the estate of the failed bank. The FDIC determines the insured amount for each depositor, including any accrued interest.

The FDIC has been busy during the recent financial crisis, arranging numerous takeovers of banks that were in jeopardy of failing. They have kept all deposits intact during these adjustments to offset any panic, and the entire system continues to function normally.

THE FEDERAL HOME LOAN BANK (FHLB) SYSTEM

Organized in 1932 to bring stability to the nation's savings associations, the Federal Home Loan Bank (FHLB) was designed to provide a central credit clearing facility for all member savings associations and to establish rules and regulations for its members.

Organization

Patterned after the Fed, the FHLB includes 12 regional Federal Home Loan Banks (FHLBanks). These district banks are distributed throughout the states and are owned by the regulated financial institutions from all 50 states. When the Federal Home Loan Bank Board was disbanded by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the new Federal Housing Finance Board (FHFB) became the regulator of the 12 FHLBanks. Under the Housing and Economic Recovery Act of 2008 (HERA), the FHFB was replaced with the Federal Housing Finance Agency (FHFA). The Federal Home Loan Bank is a government-sponsored enterprise (GSE) like Fannie Mae and Freddie Mac but managed to survive the recent economic crisis with minimal losses.

For more information on the FHLB, see www.fhlbanks.com.

Activities

Although member associations may borrow money directly from their district home loan banks for up to one year without collateral, the longer-term loans necessary for real estate finance must have collateral pledged by the borrowing association. Acceptable collateral may include government securities or established real estate mortgages held in the association's investment portfolio. If thrifts capitalize on their stock in trade, real estate mortgages, they can obtain additional funds to expand their activities, just as commercial banks can discount their commercial paper with their Federal Reserve district banks.

The thrifts throughout this country play an important role in the single-family home loan market while also participating in other forms of real estate loans. The intensity of their lending activities depends on the amount of accumulated savings, as well as reserve requirements set by the FHLB.

SUMMARY

Our monetary system is based primarily on confidence rather than on gold or silver. Money is identified as a medium of exchange; its value is largely its ability to command the purchase of goods and services. When money is available at relatively low interest rates, the economy booms. The reverse is also true.

The federal government's role in mortgage lending permeates every phase of financial activity. The federal agencies charged with determining the quantity of funds circulating in our monetary system—and, as a result, the amount of credit available and the rates of interest in effect—are the Federal Reserve System (the Fed) and the U.S. Treasury. The Fed functions as a manager of money, regulating its member banks' reserves, determining discount rates, operating in the open market for buying and selling government securi-

ties, supervising the Truth in Lending Act, and regulating and controlling all facets of the country's commercial banking system. The actions of the Fed have a strong influence on the number and dollar amounts of mortgage loans made.

The U.S. Treasury also plays an important role in real estate finance. The Treasury's primary purpose is to manage the national debt and balance the federal budget. Budget deficits are offset by issuing and selling government securities to raise funds. The amount of Treasury securities for sale determines to a large degree the quantity of money available for other investments, such as mortgages.

In addition, the Treasury is now involved in supervising all of this nation's depository institutions through the Office of the Comptroller of the Currency (OCC). All consumer deposits up to \$250,000 per account are protected by the Federal Deposit Insurance Corporation (FDIC). The Federal Home Loan Bank (FHLB) system, operating similarly to the Fed, provides funds for both short-term and long-term needs of its members at favorable interest rates. The FHLB determines its members' reserve requirements and provides its members with an important secondary source of funds.

INTERNET RESOURCES

Federal Deposit Insurance Corporation
www.fdic.gov

Federal Home Loan Bank System
www.fhlbanks.com

Federal Housing Finance Agency
www.fhfa.gov

Federal Reserve
www.federalreserve.gov

Office of the Comptroller of the Currency
www.occ.treas.gov

U.S. Treasury Department
www.treasury.gov

REVIEW QUESTIONS

1. The ability to exchange symbolic paper money for commodities in the United States is based primarily on
 - a. the gold standard.
 - b. the silver standard.
 - c. confidence.
 - d. the Federal Reserve.
2. When the Fed recommends an increase in interest rates, what is *MOST* likely to happen?
 - a. More money will flow into the economy, increasing spending.
 - b. Less money will flow into the economy, decreasing spending.
 - c. Production will increase, creating more jobs.
 - d. The demand for products will increase.
3. The *MOST* significant short-term goal of the Fed is to
 - a. act as a check clearing house for banks.
 - b. combat inflationary or deflationary pressures.
 - c. sell discounted commercial paper.
 - d. raise the overall standard of living.
4. When the Fed lowers the reserve requirements for commercial banks, what is *MOST* likely to happen?
 - a. Banks will cut back on lending.
 - b. Banks will retain less of their total assets.
 - c. More money will become available for lending.
 - d. The economy will experience a slowdown.
5. Commercial banks are able to borrow funds from the district federal reserve bank, pledging commercial paper as collateral. The interest charged is called the
 - a. prime rate.
 - b. discount rate.
 - c. federal funds rate.
 - d. open-market rate.
6. The Fed is responsible for administering the
 - a. Fair Housing Act.
 - b. Equal Credit Opportunity Act.
 - c. Real Estate Settlement Procedures Act.
 - d. Truth in Lending Act.
7. A borrower secures a new loan at 0.75 points above prime. If the prime rate is 8%, what is the rate of interest?
 - a. 0.75%
 - b. 7.25%
 - c. 8.00%
 - d. 8.75%
8. The government agency that serves as the nation's fiscal manager is the
 - a. Federal Reserve.
 - b. U.S. Treasury.
 - c. HUD.
 - d. OTS.
9. The U.S. Treasury's long-term debt instruments (for more than ten years) are called
 - a. Treasury bills.
 - b. Treasury notes.
 - c. Treasury bonds.
 - d. Treasury mortgages.
10. The FDIC insures accounts up to \$250,000 deposited in
 - a. commercial banks only.
 - b. thrifts only.
 - c. both commercial banks and thrifts.
 - d. neither commercial banks nor thrifts.

Additional Government Influence

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- list the responsibilities and activities of HUD and the CFPB;
- explain the criteria for selling property under the Interstate Land Sales Full Disclosure Act;
- identify important acts of federal legislation that affect real estate finance; and
- describe the operation of the Farm Credit System.

Community Development Block Grant Program (CDBG)

Community Reinvestment Act (CRA)
entitlement communities

Equal Credit Opportunity Act (ECOA)

Good Faith Estimate (GFE)

Home Mortgage Disclosure Act (HMDA)

Housing Choice Voucher Program

Housing and Economic Recovery Act of 2008 (HERA)

HUD-1 Settlement Statement

Interstate Land Sales Full Disclosure Act (ILSFDA)

Neighborhood Stabilization Program (NSP)

property report

Real Estate Settlement Procedures Act (RESPA)

statement of record

tax increment financing

Over the years, the federal government has established special departments and programs to regulate trends in the U.S. housing market. Some of the most significant of these will be covered in this chapter along with important federal legislation directly affecting real estate practice.

This chapter begins with a discussion of the activities of the Department of Housing and Urban Development (HUD) and the new Consumer Financial Protection Bureau (CFPB). One of HUD's primary duties is to supervise the Federal Housing Administration (FHA). HUD is also responsible for the Government National Mortgage Association (Ginnie Mae) and interstate land sales in addition to administering a variety of housing programs focused on social improvement, including low-rent housing projects, urban renewal, and rehabilitation programs.

The Consumer Financial Protection Bureau was established in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Its central mission is to make consumer financial products and services work better for Americans—whether applying for a mortgage, selecting a credit card, or using any other type of consumer financial products. Rulemaking authority for several consumer financial protection laws was transferred from seven federal agencies to the CFPB as of July 21, 2011.

This chapter also reviews current federal legislation that regulates the complex real estate marketplace. This legislation includes the Equal Credit Opportunity Act (ECOA), the Real Estate Settlement Procedures Act (RESPA), and its various disclosure requirements. It examines the role of various agencies that assist communities in attracting new industry, improving the housing of their citizens, and regulating the fair application of real estate loans.

Finally, this chapter reviews the cooperative Farm Credit System (FCS), which is designed to serve the particular financial needs of farmers and ranchers. The FCS provides funding for land acquisition, home and accessory buildings, equipment purchases, and general farm and ranch operations. The U.S. Department of Agriculture Rural and Community Development Program complements the Farm Credit System by providing funds for farmers and ranchers who are unable to secure credit from other sources.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (HUD)

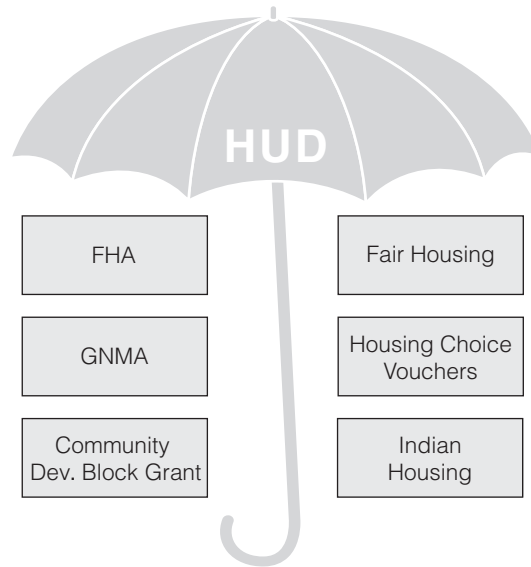
The Department of Housing and Urban Development (HUD) was given cabinet status in 1965. It consolidated a number of older federal agencies.

HUD is the federal agency responsible for national policy and programs that address America's housing needs, improve and develop U.S. communities, and enforce fair housing laws. HUD's mission is to help create a decent home and suitable living environment for all U.S. citizens.

As illustrated in Figure 3.1, HUD's primary activities include

- supervising the Federal Housing Administration (FHA),
- directing Ginnie Mae,
- enforcing the Fair Housing Act,
- managing the Housing Choice Voucher Program (formerly Section 8 Housing),
- managing the Indian Housing Act, and
- supervising public housing projects.

FIGURE 3.1 The Primary Supervisory Activities of HUD



As part of the **Housing and Economic Recovery Act of 2008 (HERA)**, HUD authorized the Neighborhood Stabilization Program (NSP). This program was designed to stabilize communities suffering from large numbers of abandoned homes and foreclosures by providing funds to all states and selected local governments to acquire and redevelop those properties. Under the American Recovery and Reinvestment Act of 2009 (ARRA), the NSP was expanded to include grants to nonprofit organizations. A third round of NSP funding was included in the Dodd-Frank Act of 2010.

In the past, HUD was also responsible for overseeing Fannie Mae and Freddie Mac operations. Regulation of these government-sponsored enterprises now falls under the Federal Housing Finance Agency (see Chapter 4). The enforcement of RESPA regulations was transferred to the CFPB in 2011.

One of the important functions of HUD is to provide information on home ownership to the public. The HUD website (www.hud.gov) is a tremendous resource for the public and for real estate practitioners.

Working under the stated mission to “create strong, sustainable, inclusive communities and quality affordable homes for all,” HUD’s Strategic Framework for 2014–2018 emphasizes the following strategic goals:

- Strengthen the nation’s housing market to bolster the economy and protect consumers
- Meet the need for quality affordable rental homes
- Use housing as a platform for improving quality of life
- Build inclusive and sustainable communities free from discrimination

Each of the strategic goals are backed up with strategic objectives that are specific to each goal. The complete 2014–2018 plan is available at www.hud.gov.

The Federal Housing Administration (FHA) is covered in Chapter 8, and Ginnie Mae is covered in Chapter 4. Additional HUD responsibilities will be covered in this chapter.

Fair Housing

The HUD Office of Fair Housing and Equal Opportunity (FHEO) enforces the Fair Housing Act (Title VIII of the Civil Rights Act of 1968 prohibiting discrimination in the sale, rental, and financing of dwellings based on race, color, national origin, religion, sex, familial status, and disability) and other civil rights laws, including

- Title VI of the Civil Rights Act of 1964,
- Section 109 of the Housing and Community Development Act of 1974,
- Section 504 of the Rehabilitation Act of 1973,
- Title II of the Americans with Disabilities Act of 1990,
- the Age Discrimination Act of 1975,
- Title IX of the Education Amendments Act of 1972, and
- the Architectural Barriers Act of 1968.

In some cases, fair housing complaints are handled at the state level when the state has an equivalent enforcement program.

Community Development Block Grant (CDBG)

The **Community Development Block Grant (CDBG)** program is one of HUD's longest continuously run programs. Since its inception in 1974, the CDBG program has helped communities with economic development, job opportunities, and housing rehabilitation. CDBG funds have been used to construct and improve public facilities such as water, sewer, streets, and neighborhood centers; to purchase real property; and to assist private businesses.

CDBG funds are split between states and **entitlement communities**, defined as metropolitan cities with populations of at least 50,000 and urban counties with populations of at least 200,000. States distribute to non-entitlement communities. Annual grants are provided to 1,209 general units of state and local government. The amount of each grant is determined based on a formula made up of different measures of community needs such as the poverty level, population data, age, and density of housing. Seventy percent of CDBG funds must benefit low-income and moderate-income families.

Neighborhood Stabilization Program (NSP)

The **Neighborhood Stabilization Program (NSP)** was established to help stabilize communities that have suffered from foreclosed and abandoned homes. NSP funds authorized under the Housing and Economic Recovery Act (HERA) (called NSP1 funds) provided grants to states and selected local governments to purchase and redevelop such properties. NSP2 funds were authorized under the American Recovery and Reinvestment Act

(ARRA) to include nonprofit entities on a competitive basis for grants and to fund \$50 million to national and local technical assistance providers. NSP3 funds were authorized under the Dodd-Frank Act of 2010 to provide a third round of grants to states and local governments on a formula basis.

Interstate Land Sales

The **Interstate Land Sales Full Disclosure Act (ILSFDA)**, passed by Congress in 1968, established the informational criteria for marketing residential land to potential buyers. Designed to reduce fraud in the sale of land by developers, the law requires that anyone selling or leasing 25 or more lots of unimproved land as part of a common plan in interstate commerce must comply with the act's provisions. The exceptions include subdivisions of five acres or more, cemetery land, commercial and industrial land, and any residential subdivision marketed exclusively in the state where it is located.

A developer must provide HUD with a **statement of record** that includes explanations and descriptions of existing and proposed encumbrances, improvements, utilities, schools, recreation areas, roads, and all services to be provided for the residents' use. A **property report** must be delivered to the buyer prior to the purchase of the property. The seller must have a signed receipt from the buyer indicating the buyer received the property report. If a property report is received within 48 hours prior to signing, the buyers have the right to change their minds within seven days, cancel their contract, and receive a return of any deposits made. However, if the report is not received within the allotted time, the buyers may legally rescind their contract at any time.

Although the ILSFDA was once a subagency of HUD, its enforcement has been shifted to the new Consumer Financial Protection Bureau. New regulations and guidelines will be provided by the CFPB.

Urban Renewal

HUD sponsors urban renewal projects that encompass entire neighborhoods as well as specific properties. Neighborhood renewal involves large-scale planning, including site acquisition, site clearance, construction, and disposition. Urban renewal originates at the community level, where a workable plan is developed and then sent to HUD for approval and sponsorship.

In addition to providing funds for slum clearance, HUD makes loans and grants to owners and tenants in depressed areas for rehabilitating their properties. Grants are also available to demolish structures unfit for habitation.

Public Housing

HUD provides financial assistance to local authorities for acquisition and operation of properties for public housing programs. This assistance includes grant monies, housing subsidies, and other means of support. HUD also helps finance public housing agency projects to integrate public housing into surrounding communities and to provide residents the skills to contribute to their communities.

Housing Choice Voucher Program

The HUD **Housing Choice Voucher Program** is the federal government's major program for assisting very-low-income families, the elderly, and the disabled to obtain safe and affordable housing. The program was originally only for rental subsidy and was called Section 8. Families seeking assistance apply through their local public housing agency. Tenants have the freedom to select housing where they want to live within a standard rent range. The rent subsidies are paid to owners and consist of the difference between what the tenant can pay and the contracted rent.

Under legislation passed in 2001, individual Public Housing Authorities (PHA) have the option to use a portion of their Housing Choice Vouchers to assist first-time homebuyers. PHAs individually make the determination of how much of their funding they wish to allocate to this Homeownership Voucher Program. FHA sets minimum income and employment requirements, but other eligibility requirements are set by the PHA. For example, recipients may be required to attend a homeownership and housing counseling program.

Native American Housing

Through the **Office of Native American Programs (ONAP)**, HUD promotes providing decent, safe, and affordable housing for lower-income Native American, Alaska Native, and Native Hawaiian families. ONAP works closely with tribes and tribally designated housing entities to administer their own programs.

Other Programs

HUD offers monetary support to state and local governments and to nonprofit organizations to assist homeless individuals and families to move from the streets to temporary shelters to supportive housing and, ideally, back into the mainstream of American life. HUD also helps fund cooperative housing for low-income persons, housing for the elderly, mortgage interest subsidies, relocation assistance, college housing, disaster area reconstruction, and housing in isolated areas.

HUD provides a Good Neighbor Next Door sales program for law enforcement officers, pre-kindergarten through 12th-grade teachers, firefighters, and emergency medical technicians. A discount of 50% of the sales price is provided in return for a commitment to live in the property for a minimum of 36 months.

For full details on all of HUD's special programs, see www.hud.gov.

CONSUMER FINANCIAL PROTECTION BUREAU

The CFPB was charged by the Dodd-Frank Act to issue rules that combine the disclosures required in the Good Faith Estimate and the Truth-in-Lending Disclosure. In November 2013, the CFPB released the 1,900-page RESPA-TILA Integrated Disclosures final rule. Under the new rule, there are two disclosures: the three-page Loan Estimate (replaces the GFE and initial TILA forms) and the Closing Disclosure (replaces HUD-1 and the final TILA disclosure). The new forms are mandated to go into effect on August 1, 2015.

Applications taken right up until July 31, 2015, must use the old forms. (See Appendices A and B.)

Loan Estimate

The Loan Estimate provides a summary of the loan terms, estimated loan costs, other closing costs, and additional application disclosures. This form could be used to compare different loan products. The Loan Estimate must be provided to the borrower within three business days from application. *Application* is now defined by the CFPB as the submission of six pieces of information: (1) the consumer's name, (2) the consumer's income, (3) the consumer's Social Security number to obtain a credit report, (4) the property address, (5) an estimate of value of the property, and (6) the mortgage loan amount sought. This is slightly different from the original requirements of Regulation X – RESPA. A business day is defined as a day that the lender's offices are open. (See Appendix L.)

Closing Disclosure

The Closing Disclosure provides a summary of the actual loan terms, the loan costs, other settlement costs, and additional closing disclosures. The Closing Disclosure must be provided to the consumer at least three business days before closing. If there are significant changes, an updated Closing Disclosure must be prepared and there will be another three-day waiting period. The three business days are defined, as in Regulation Z – TILA, as any day other than a Sunday or legal holidays. Changes that would require a new three-day waiting period are (1) changes to the APR greater than $\frac{1}{8}$ of a percent, (2) changes to the loan product, or (3) the addition of a prepayment penalty. (See Appendix M.)

The CFPB has provided a September 2014 revised edition of the *TILA-RESPA Integrated Disclosure Rule, Small Entity Compliance Guide* that includes sample forms. It is available at www.consumerfinance.gov.

The CFPB released new rules that took effect on January 10, 2014, on how mortgage servicers must treat borrowers. The rules apply to all mortgage servicers with 5,000 or more loans. The goal of the new regulations is to make sure that servicers cannot take advantage of borrowers who fall behind on their payments. Despite concern in the mortgage lending industry regarding the thousands of pages of rules and new processes that are now required, most lenders were able to develop coping strategies and to implement the new regulations in a timely fashion.

The new rules require the servicer to

1. provide billing information in writing;
2. provide at least two months' warning if there is going to be a change in an adjustable-rate mortgage interest rate that will change the payment amount;
3. promptly credit mortgage payments;
4. respond quickly when asked about paying off a loan;
5. not charge for insurance that is not needed or over-charge for force-placed insurance;
6. quickly resolve complaints and share information;

7. have and follow good customer service policies and procedures;
8. contact the borrower to help when the borrower is having trouble making payments;
9. work with the borrower who is having trouble paying the mortgage before starting or continuing foreclosure; and
10. allow the borrower to seek review of the mortgage servicer's decision about a loan workout request.

The CFPB has prepared a brochure for consumers that provides contact information for anyone who does not believe that their mortgage servicer is following the new rules. The brochure and other CFPB news is available at www.consumerfinance.gov.

SIGNIFICANT FEDERAL LEGISLATION

In the past, real estate transactions were virtually unregulated, and each party was assumed to be knowledgeable about the facts and conditions surrounding the sale and financing of a property. As the marketplace evolved and became more complex, it also became clear that many purchasers or sellers were not well informed. As a result, some significant federal legislation was passed that has become standard practice in every real estate transaction.

The Federal Equal Credit Opportunity Act (ECOA)

The **Equal Credit Opportunity Act (ECOA)** is Title VII of the Consumer Protection Act. It prohibits lenders from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, or dependency on public assistance. The basic provisions of the act include the following:

- The lender may not ask if the applicant is divorced or widowed. However, the lender may ask if the borrower is married, unmarried, or separated. The term *unmarried* denotes a single, divorced, or widowed person and, in a community property state, is of particular interest to local lenders.
- The lender may not ask about the receipt of alimony or child support unless the borrower intends to use such income to qualify for the loan. The lender may ask about any obligations to pay alimony or child support.
- The lender may not seek any information about birth control practices or the child-bearing capabilities or intentions of the borrower or co-borrower.
- The lender may not request information about the spouse or former spouse of the applicant unless that person will be contractually liable for repayment or the couple lives in a community property state.
- The lender may not discount or exclude any income because of the source of that income.

- The lender must report credit information on married couples separately in the name of each spouse.
- The lender may ask about the race or national origin of the applicant, but the borrowers can refuse to answer without fear of jeopardizing their loan.

The ECOA also prohibits lenders from discriminating against credit applicants who exercise their rights under truth-in-lending laws. In addition, lenders and other creditors must inform all rejected applicants in writing of the principal reasons why credit was denied or terminated. The focus of the ECOA is to ensure that all qualified persons have equal access to credit.

Both the Justice Department and HUD are charged with protecting borrowers from discrimination in lending practices under the fair housing laws and ECOA. An example of ECOA's effectiveness is the case against the Chevy Chase Federal Savings Bank in Washington, DC, which was accused of violating the racial discrimination standards. The bank denied all allegations but agreed to invest \$11 million to open at least one new branch in an African American area of the city. The bank also agreed to provide eligible borrowers discounted interest rates and grants equaling 2% of the loan down payments.

The Real Estate Settlement Procedures Act (RESPA)

Formerly administered under the FHA, but now under the CFPB, the **Real Estate Settlement Procedures Act (RESPA)** is designed to protect the participants in a real estate transaction by providing closing cost information so they better understand the settlement procedures. RESPA covers the sale of residential properties and the acquisition of mortgage loans, including home equity loans, second mortgages, and refinancing loans on residential properties.

Violations of RESPA are subject to severe penalties such as triple damages, fines, and even imprisonment. RESPA covers almost every service provider involved in the purchase of a home, including

- real estate brokers and agents,
- mortgage brokers and mortgage bankers,
- title companies and title agents,
- home warranty companies,
- hazard insurance agents,
- appraisers,
- flood insurers and tax service suppliers, and
- home and pest inspectors.

Real estate brokers or agents are prohibited from receiving anything “of value” for referring business to another real estate service provider or from splitting fees received for settlement services unless the fee is paid for an actual service. Exemptions to the referral restrictions are (1) promotional and educational activities, (2) payment for goods

provided or service performed, and (3) affiliated business arrangements. For a detailed description of each of the exempt categories and to see examples of permissible activities and payments, see www.hud.gov.

In 2012, the House passed a bill that would have taken home warranty companies off of the RESPA list, but the Senate failed to take action, so it remains in place.

Disclosures Under RESPA. In order to protect participants in a real estate transaction, RESPA requires all service costs to be disclosed at various times during the process. Disclosures must be made during the time of a loan application, before settlement/closing, at settlement, and after settlement.

Disclosure at the Time of a Loan Application. At the beginning of the mortgage loan process, the lender must provide the borrower the following three items:

- A Special Information Booklet containing information on real estate settlement services must be provided.
- Within three business days, a **Good Faith Estimate (GFE)** of settlement costs listing the charges the borrower is likely to pay at closing and indicating whether the borrower has to use a specific settlement service must be provided. A new GFE form developed by HUD went into effect on January 1, 2010 (see Appendix A). The new GFE gives specific details on all loan terms, closing costs, and related fees, giving the borrowers a better opportunity to compare different loan products. The new GFE has zero tolerance for any change to significant aspects of the estimate. This GFE is being replaced as of August 1, 2015, with the new Loan Estimate form.
- A mortgage servicing disclosure statement informing the borrower whether the lender intends to keep the loan or transfer it to a different lender for servicing, in addition to information on how the borrower can resolve complaints, must be provided.

Disclosures Before Settlement/Closing. Prior to settlement, an Affiliated Business Arrangement (AFBA) Disclosure is required whenever a settlement service provider refers the borrower to a firm with which the servicer has any connection, such as common ownership. The service usually cannot force a borrower to use a connected firm. A preliminary copy of a **HUD-1 Settlement Statement** (see Appendix B) is required if the borrower requests it 24 hours prior to closing. This form estimates all settlement charges that must be paid by the participants. The borrower must also receive a copy of the truth-in-lending statement prior to closing that discloses the annual percentage rate and total costs of credit involved in the transaction. The HUD-1 form is being replaced with the Closing Disclosure form as of August 1, 2015. The form must be provided to the consumer three days prior to closing. The new form also replaces the final truth-in-lending statement.

Disclosures at Settlement. The HUD-1 Settlement Statement is distributed at closing and shows the actual charges incurred by the participants. In addition, an initial escrow statement is required at closing or within 45 days of closing. This statement itemizes the estimated taxes, insurance premiums, and other charges that must be paid from the escrow account during the first year of the loan. RESPA limits the amount of “cushion” the lender may require in the escrow account to two months of payments. It is now fed-

eral law to include a lead-based paint disclosure on all properties built before 1978. The new HUD-1 form became effective January 1, 2010, and lists the actual costs side-by-side with the estimated costs, giving borrowers documentation for their records plus protection from possible fraud or predatory lending practices. This information will not be included in the new Closing Disclosure form. If there are significant changes, an updated form must be prepared with a new waiting period of three days.

Disclosures After Settlement. After settlement, an Annual Escrow Statement must be delivered by the loan servicer to the borrower. This document enumerates all escrow deposits and payments during the past year. It indicates any shortages or surpluses in the escrow account and informs the borrower how to remedy them. If the loan service is transferred to another servicer, a Servicing Transfer Statement is delivered to the borrower.

Truth in Lending Act (TILA)—Regulation Z

The Truth in Lending Act, Title I of the Consumer Credit Protection Act of 1968, requires that all costs of financing be disclosed to the consumer. The intent of this act is to ensure that consumers can compare the cost of making a purchase using credit to the cost of making the same purchase with cash. Important TILA disclosures that relate to mortgage lending are listed in the following:

- The annual percentage rate (APR) discloses the true yield achieved by the lender through a combination of the stated rate of interest, any discount points, and additional lender fees. The APR must be disclosed to the consumer prior to making the loan and in all advertising.
- Regulation Z requires full disclosure of all elements of financing. Disclosure of any one of the “trigger” terms—rate of interest, number of payments, term of the loan, amount of monthly payment, down payment amount, or percentage—requires full disclosure of all of the terms.
- Adjustable-rate mortgages must include disclosure of all potential rate increases.

TILA disclosures are always required for credit extended for the purchase of real property. If credit is to be extended for the purchase of personal property in excess of \$25,000, or if repayment will be made in more than four installments, TILA disclosure is required. There is sometimes a misconception on the part of the public that all credit agreements have a three-day right of rescission. There is no right of rescission for credit extended for the purchase or construction of real property. Credit extended for a home equity loan or refinancing does have the three-day right of rescission.

In Practice

A real estate licensee recently represented a buyer as her buyer agent for the purchase of a new town house. The licensee recommended three different loan officers for the buyer to contact regarding obtaining a home mortgage loan. The buyer picked one and was very happy with him, until this morning, when she received a truth-in-lending statement in the mail. She immediately called the licensee, obviously very upset. “You and the loan officer both assured

me that I was getting a 6.5% loan and that I was going to be able to borrow \$200,000. Today I get this statement in the mail saying that the interest rate will be 6.82% and that I'm only borrowing \$194,000. Now I don't know what or who to believe."

This is not an uncommon reaction to receipt of the truth-in-lending statement. Fortunately, the licensee has dealt with this many times before and was quickly able to calm the buyer down. He then explained to her that the Truth in Lending Act requires the lender to disclose exactly how much they are earning on the loan, including any loan fees and discount points that may have been charged. Because there were three points on this \$200,000 loan, the lender only sends a check for \$194,000 to the settlement table (they receive the other \$6,000 in points, paid by the buyer, seller, or both). When the discount points and additional loan fees of \$500 are calculated, the lender's actual yield becomes 6.82%.

The Community Reinvestment Act (CRA)

The **Community Reinvestment Act (CRA)**, passed by Congress in 1977, ensures that financial institutions pursue their responsibilities to meet both the deposit and the credit needs of members of the communities in which they are chartered. Each institution is required to delineate its community, specify the types of credit services it offers, post a public notice stating that the institution is being reviewed by a federal supervisory agency, and prepare a community reinvestment statement to be made available to the public. The act covers the majority of U.S. financial institutions. The federal supervisory agency would include the Comptroller of the Currency and the board of governors of the Fed, the FDIC, and the new Consumer Financial Protection Bureau.

The 1990s were a period of strong CRA enforcement due to the number of mergers and acquisitions taking place. The act was revised in 1995 and again in 2005.

The Home Mortgage Disclosure Act (HMDA)

Under the **Home Mortgage Disclosure Act (HMDA)**, all mortgage originators are required to report information relating to income level, racial characteristics, and gender of mortgage applicants. This includes loans originated as well as applications rejected.

STATE AND LOCAL PROGRAMS

Various states have established agencies to provide financial assistance at the community level for special real estate developments. These agencies are grouped into categories—one to assist local communities in attracting new industry and another to improve the housing of its citizens. A complete discussion of bond programs that may be used by states or local governments can be found in Chapter 5. Another source of funding for state and local redevelopment programs are the Neighborhood Stabilization Program grants previously described in this chapter.

Industrial Development Agencies

Under legislation from the state government, communities have organized industrial development agencies empowered to purchase and improve land for industrial and office parks. These activities are funded by industrial revenue bonds (IRBs) backed by a state's bonding credit. Some funds are also raised through voluntary contributions from citizens interested in expanding the economic base of their community.

Community growth is the ultimate goal behind the development of industrial land. By offering preplanned industrial park sites, as well as other amenities and incentives, a community can attract new industrial activities. IRBs can create new jobs and more commercial activity in the local area, with commensurate increases in profits for businesses and tax revenues for the community. Many U.S. communities have used the IRB approach to achieve growth and have been successful in attracting new industries. The interest paid on these bonds is federally income tax free to the bond purchaser, thus providing a lower borrowing interest rate to the developer.

Mortgage Insurance Programs

Some states have developed special real estate mortgage insurance programs of their own, funded by the state itself. The state sells either general obligation bonds repaid from state income tax collections or, more frequently, revenue bonds repaid from the mortgage insurance premiums collected. The funds raised from the sale of these bonds are used primarily as reserves for backing specific development projects. For instance, if a community wished to embark on a rehabilitation project, money could be secured from private sources to pursue this objective. If the project were approved, the state would issue insurance for repayment of the funds so the work could proceed.

Money raised from the sale of state bonds might also be used for direct loan purposes, such as special loans for the purchase of farm or ranch land. In Virginia, the Virginia Housing Development Authority (VHDA) provides funding for low- to moderate-income first-time homebuyers in the state through the sale of bonds and securities. Other states with special housing programs include California, Indiana, Michigan, South Dakota, Tennessee, Texas, and Wisconsin. Some of these socially oriented programs include programs for veterans and for low-income housing projects.

Community Redevelopment Agencies

Local governments may establish community redevelopment agencies for expansion of the supply of low-income housing. These agencies are supervised by city council members and can acquire property by eminent domain. Any building program must agree to allocate 30% of the rental units for low-income tenants before it can be approved. Replacement housing must be provided within or outside the redevelopment area for every person displaced by the project.

Tax Increment Financing. Projects of community redevelopment agencies are funded in large part with **tax increment financing**. This technique allocates the increased property tax revenues derived from redevelopment to pay the debts incurred in improving the area. It requires that property taxes be frozen as of the date the redevelopment plan is

adopted, with any excess taxes applied directly to satisfy the debt or used as security for the sale of bonds. After the debts have been satisfied, the taxes may rise to current levels, offsetting additional community costs brought about by the improvements.

AGRICULTURAL LENDING

Farm loans have special cyclical requirements. The values of farm and ranch lands depend on productivity, and productivity in turn depends on management expertise and climatic conditions. Although management skills can be evaluated based on past experience, nobody can estimate the influence of nature on each season's crops, and farm and ranch loans acquire a unique risk factor.

Agricultural loans have to be designed with as much flexibility as possible. Rather than following a rigid payment pattern, their design must allow the farmer-borrowers the opportunity to pay when they can. It is essential, for instance, that the principal amount is not due in a bad crop year. The terms of the loans need to be lengthened, up to 40 years in some cases, to allow for those years when crops fail and no payments can be made. Farmer-borrowers also need an opportunity to pay larger portions of the principal, in addition to the interest required, during a good year so that they can repay their loans in full over the longer time period.

Farmer-borrowers need to be able to extend, expand, and otherwise adjust their loans depending on unforeseen circumstances. The extension and expansion techniques designed to satisfy the special problems of the farmers are defined as open-end mortgages. As a last resort for a distressed farmer-borrower, a moratorium on payments occasionally is used to offset imminent foreclosures brought on by situations outside the borrower's control. Open-end mortgages and moratoriums will be discussed in later chapters of this book.

The Farm Credit System (FCS)

The Farm Credit System (FCS) was created by Congress in 1916 to provide American agriculture with a source of sound, dependable credit at competitive rates of interest. Through approximately 90 local Farm Credit associations and five Farm Credit Banks, more than \$160 billion in credit and related services have been provided to farmers, ranchers, producers, and harvesters of aquatic products, rural homeowners, timber harvesters, agricultural cooperatives, rural utility systems, and agribusinesses.

The FCS banks do not take deposits. The funds used for lending are raised through the sale of bonds and notes in national capital markets. The Federal Farm Credit Banks Funding Corporation manages the sale of system-wide debt securities. Purchasers of these securities are assured of timely payment of principal and interest by the Farm Credit System Insurance Corporation (FCSIC).

Long-term mortgage loans are generally made by Farm Credit Banks, Federal Land Bank Associations, or Federal Land Credit Associations. Short-term and intermediate-term loans are usually made by Production Credit Associations. In some cases, these entities have combined to form Agriculture Credit Associations that provide both long- and

short-term loans. The Farm Credit Administration (FCA) is an independent federal regulator responsible for examining and ensuring the soundness of all FCS institutions.

See www.agfirst.com and www.fca.gov for more information on the Farm Credit System.

Federal Agriculture Mortgage Corporation (Farmer Mac)

The Federal Agriculture Mortgage Corporation, known as Farmer Mac, was created by Congress to provide a secondary market for agricultural and rural housing mortgage loans. In the Farmer Mac I Program, Farmer Mac purchases qualified loans from agricultural mortgage lenders, thereby replenishing the lenders' source of funds to make new loans. The loans are then packaged and sold as securities. In the Farmer Mac II Program, Farmer Mac purchases guaranteed portions of USDA loans. Farmer Mac also purchases qualified rural utility loans or guarantees payment of interest and principal of securities backed by pools of such loans.

Although both the Farm Credit System and Farmer Mac were created and chartered by Congress, neither is funded by taxpayers. Farmer Mac securities are sold on the over-the-counter desk of the New York Stock Exchange. See www.farmermac.com for more information on the program.

The U.S. Department of Agriculture Rural and Community Development Program (USDA Rural Development)

The activities of the Farm Credit System are complemented by the USDA. This governmental unit was created in 1994 to combine the Farmers Home Administration (FmHA), the Rural Development Administration, the Rural Electrification Administration, and the Agricultural Cooperative Service.

The USDA Rural and Community Development Program [Rural Housing Service (RHS)] forges new partnerships with rural communities to reverse the downward spiral of rural job losses, out-migration, and diminishing services. The program funds projects that bring housing, community facilities, utilities, and other services to rural areas. The USDA also provides technical assistance and financial backing for rural businesses and cooperatives to create quality jobs in rural areas. The USDA has released new maps showing areas that are eligible for rural development housing programs.

See www.rurdev.usda.gov for more information on the program.

SUMMARY

This chapter examined the Department of Housing and Urban Development (HUD), which participates actively in real estate finance. In addition to supporting the FHA and Ginnie Mae, HUD promotes various urban renewal projects, area rehabilitation ventures, and open-space developments. Among its other socially oriented housing activities are public housing programs, cooperative housing for low-income persons, mortgage interest subsidies, relocation aid, disaster area construction, and isolated area housing. The new Consumer Financial Protection Bureau is also covered in this chapter.

Federal legislation regulating real estate finance was examined, including the Equal Credit Opportunity Act (ECOA), the Community Reinvestment Act (CRA), the Real Estate Settlement Procedures Act (RESPA), and the Truth in Lending Act (TILA). ECOA prohibits lenders from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, or dependency on public assistance. The Community Reinvestment Act requires all federally regulated financial institutions to expand their responsibilities to meet the needs of all citizens of a community. RESPA is designed to prevent abuses of buyers and sellers by providing estimated costs of a real estate transaction before closing to avoid any last-minute shocks, and TILA requires a full disclosure of all costs of credit.

Most states have established financing agencies of their own to help develop industry in various communities and provide the means to improve the housing requirements of their citizens. These agencies frequently use bond issues to raise funds for their programs, some of which are repaid with tax increments.

The last section of this chapter reviewed the Farm Credit System, which originated under the federal Farm Loan Act of 1916 and serves the particular financial needs of farmers, ranchers, producers and harvesters of aquatic products, rural homeowners, and selected farm-related businesses. Complementing the various agencies of the Farm Credit System, the U.S. Department of Agriculture Rural and Community Development makes loans to farmers and ranchers unable to secure credit from other sources.

INTERNET RESOURCES

Consumer Financial Protection Bureau

www.consumerfinance.gov

Department of Housing and Urban Development

www.hud.gov

Fannie Mae

www.fanniemae.com

Farm Credit Administration

www.fca.gov

Farm Credit Bank

www.agfirst.com

Federal Agricultural Mortgage Corporation

www.farmermac.com

Freddie Mac

www.freddiemac.com

Ginnie Mae

www.ginniemae.gov

U.S. Department of Agriculture
www.usda.gov

USDA Rural Development
www.rurdev.usda.gov

REVIEW QUESTIONS

1. HUD is responsible for all of the following *EXCEPT*
 - a. FHA.
 - b. Ginnie Mae.
 - c. Fannie Mae.
 - d. Community Development Block Grants.
2. A developer is planning a new subdivision of building lots. In which case will it be subject to the Interstate Land Sales Full Disclosure Act?
 - a. If all lots will be 10 acres
 - b. If the subdivision will consist of 20 individual lots
 - c. If the subdivision will be marketed out of state
 - d. If the subdivision will be marketed locally
3. The Housing Choice Voucher Program allows a public housing authority to use a portion of its available funds to
 - a. provide rehabilitation funds for depressed areas.
 - b. improve public water and sewer systems.
 - c. provide mortgage payment subsidies for qualified applicants.
 - d. build psychiatric hospitals.
4. While taking a loan application from a married couple, a loan officer inquired about the wife's ability to have more children. Which federal act is the lender violating?
 - a. RESPA
 - b. ECOA
 - c. TILA
 - d. HMDA
5. RESPA does *NOT* require that the lender provide a borrower with a
 - a. Good Faith Estimate.
 - b. truth-in-lending statement.
 - c. HUD-1 closing statement.
 - d. right of rescission.
6. The disclosure of all elements of financing in advertising is required under
 - a. APR.
 - b. GFE.
 - c. CRA.
 - d. Regulation Z of TILA.
7. The Community Reinvestment Act requires a lender to
 - a. provide housing voucher certificates when requested.
 - b. offer credit to all qualified members of the community served.
 - c. build low-cost housing.
 - d. become a member of the Federal Reserve system.
8. Selling industrial revenue bonds (IRBs) backed by the state's bonding credit is one way for a local community to
 - a. build a new high school.
 - b. purchase and improve land for an industrial or office park.
 - c. rehabilitate the city jail.
 - d. provide street lights throughout the downtown area.
9. The Neighborhood Stabilization Program provides grants for the
 - a. purchase and redevelopment of foreclosed properties.
 - b. development of low-cost rental projects.
 - c. construction of public facilities.
 - d. exclusive benefit of low-income families.
10. The Farm Credit System network of financial institutions may provide credit to farmers and ranchers for all *EXCEPT* the
 - a. processing and marketing of goods.
 - b. purchase of farm equipment.
 - c. rehab of farm outbuildings.
 - d. purchase of a home in an urban area.

The Secondary Mortgage Market

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- describe the original purpose and organization of Fannie Mae and Freddie Mac and how they have evolved since then;
- explain the role of the Federal Housing Finance Agency (FHFA);
- list underwriting guidelines that must be followed in order to sell mortgage loans to Fannie Mae or Freddie Mac;
- explain the role of Ginnie Mae in the secondary market; and
- briefly describe the function of the FHLB, Farmer Mac, and REMICs.

administered price system

collateralized mortgage obligation (CMO)

conforming loan

Desktop Originator® (DO)

Desktop Underwriter® (DU)

Fannie Mae

Federal Home Loan Bank (FHLB)

Federal Housing Finance Agency (FHFA)

Freddie Mac

Ginnie Mae

government-sponsored enterprise (GSE)

jumbo loans

Loan Prospector®

nonconforming loan

par

participation certificates (PCs)

pass-through certificates

premium

primary lender

qualified residential mortgage (QRM)

real estate mortgage investment conduits (REMICs)

The secondary mortgage market is designed to deal in real estate mortgages, buying them from loan originators and selling them to investors or pooling them to enlarge the markets for these types of securities. When mortgages are purchased from

primary lenders (such as banks, thrifts, and mortgage companies), also known as loan originators, the money generated acts to replenish the supply necessary for continued lending activities. When mortgages are sold to investors such as Fannie Mae, Freddie Mac, and other financial institutions, funds are recirculated nationally making credit available to borrowers in all geographic locations.

MAJOR PARTICIPANTS IN THE SECONDARY MARKET

The major participants in the secondary mortgage market are Fannie Mae (formerly the Federal National Mortgage Association), Freddie Mac (formerly the Federal Home Loan Mortgage Corporation), and Ginnie Mae (formerly the Government National Mortgage Association). Other participants include the Federal Home Loan Bank (FHLB), the Federal Agricultural Mortgage Corporation (Farmer Mac), and many private real estate mortgage investment conduits (REMICs) that use mortgage-backed securities (MBSs) to collateralize their own securities.

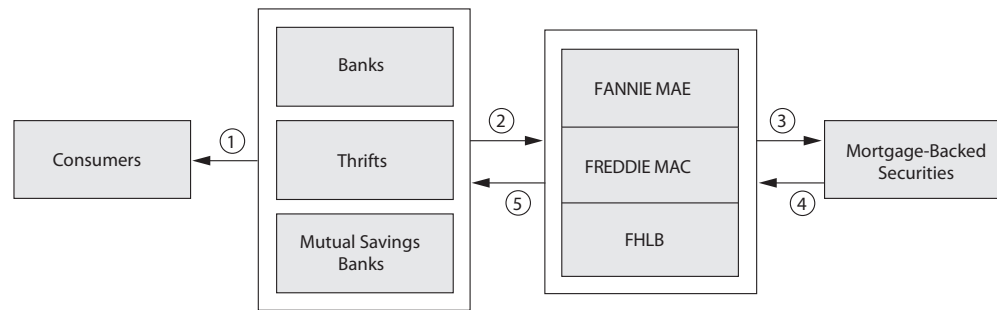
The financial market for real estate loans is based on the ability of loan originators to dispose of their new loans as quickly as possible in the secondary market as they need to replenish funds and strive to manage the interest rate risk that arises from long-term, fixed-rate mortgages. This results in loan originators having to closely follow the loan guidelines established by the secondary market investors.

This chapter examines the participants in the secondary mortgage market and how their activities facilitate the national distribution of funds to the primary markets. Figure 4.1 illustrates an example of how the process works.

Collateralized Mortgage Obligation (CMO)

The trend toward selling real estate loans has led to the development of a major new group of secondary market investors. Based on the concept of collateralization—the pooling together of homogenous types of mortgages to use as collateral for issuing marketable securities—private companies have emerged to challenge the dominant positions of Fannie Mae and Freddie Mac. Wall Street developed a market for these **collateralized mortgage obligation (CMO)** loans tied to short-term interest rates. These adjustable-rate mortgages were often sold to the consumer on the premise that they could always refinance before the initial rate increased. Subprime lending doubled and tripled as these high-risk types of loans were originated, often based on lax underwriting standards. When Fannie Mae and Freddie Mac saw their market shares drop, they too began purchasing these “exotic” loans. Operating as real estate mortgage investment conduits (REMICs), life insurance companies, pension funds, securities dealers, and other financial institutions

FIGURE 4.1 The Secondary Mortgage Market



Step 1: Primary Market Lenders (Banks, Thrifts, Mutual Savings Banks, etc.) Provide Mortgages to Consumers.

Step 2: Primary Market Lenders Sell Loan Packages to Fannie Mae, Freddie Mac, and Federal Home Loan Bank.

Step 3: Fannie Mae, Freddie Mac, and FHLB Sell Mortgage-Backed Securities on the Open Market.

Step 4: Monies Received through the Sale of Mortgage-Backed Securities Provide Fannie Mae, Freddie Mac, and FHLB with Funds to Purchase More Loan Packages from the Primary Lenders.

Step 5: By Purchasing More Loan Packages, Fannie Mae, Freddie Mac, and FHLB Provide the Primary Market Lenders with Additional Money to Fund More Mortgage Loans for Consumers.

began creating new loans for their own portfolios, as well as buying and selling loans from other originators.

...and the walls came crashing down! Inevitably, the bubble burst. As housing prices began to decline in 2006 and borrowers were unable to refinance due to lowered property values, the rate of foreclosure went up throughout the country, and by 2007, both Wall Street and Main Street were in trouble.

Almost all of the subprime lenders went under and by 2011, most of the private mortgage insurance companies were headed for failure. In September 2008, Fannie Mae and Freddie Mac were both placed in conservatorship under the Federal Housing Finance Agency (FHFA). The conservatorship has continued far longer than was originally anticipated and was still in place in 2014. One of the primary goals of the FHFA was to stabilize the operations of Fannie Mae and Freddie Mac in order to continue the functions of the secondary market. By 2013, that phase appears to have been successful. The second goal focused on foreclosure prevention efforts. Over 2.7 million foreclosure prevention actions indicate that the second phase is also having some success.

Much discussion has taken place about whether or not Fannie Mae and Freddie Mac should continue at a corporate level in the secondary market. The new director of FHFA, Melvin Watt, indicated that Fannie Mae and Freddie Mac should remain in place with no reduction in current loan limits until the level of private investors increases. The FHFA will continue the government's role in the mortgage finance market.

The following section will discuss the background and history of Fannie Mae and Freddie Mac with a brief description of some of their loan products.

THE GOVERNMENT-SPONSORED ENTERPRISES (GSEs)

Fannie Mae and **Freddie Mac** are called **government-sponsored enterprises (GSEs)**. (The Federal Home Loan Bank is also a GSE but will be covered separately later in this chapter.) Due to their GSE status, they were not required to register their securities with the Securities and Exchange Commission or to pay state and local corporate income tax. They were also allowed to carry a large line of credit with the Treasury Department. Although their debt securities and mortgage-backed securities (MBSs) were never officially backed by the federal government, there was a public conception that the government would never allow Fannie and Freddie to default on their obligations.

Over four decades, Fannie Mae and Freddie Mac grew rapidly and dominated the secondary market for **conforming loans** (loans that fit their qualifying standards). They both developed numerous loan products that enabled more potential homebuyers to obtain mortgage loans at low interest rates. Unfortunately, when the overall housing market began to decline in 2006, housing prices dropped and made it impossible for at-risk homeowners to either sell or refinance. The two GSEs suffered large losses in areas of their portfolios such as subprime loans and mortgage-backed securities issued by private companies.

The **Federal Housing Finance Agency (FHFA)** was established under the Federal Housing Reform Act of 2007 as an independent agency to regulate Fannie Mae, Freddie Mac, and the Federal Home Loan Bank (FHLB). At that point, these three enterprises had \$5.4 trillion of guaranteed mortgage-backed securities (MBSs) and debt outstanding with an 80% market share of all new mortgages. Despite the best efforts of the enterprises to provide liquidity to the conforming mortgage market while raising and maintaining capital, their ability to fulfill their mission deteriorated, raising concern over both safety and soundness issues.

By September of 2008, Fannie Mae and Freddie Mac had outstanding guarantees of \$3.8 trillion, and there were serious doubts as to whether they would be able to cover the potential losses. On September 6, 2008, acting under the Housing and Economic Recovery Act of 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorship. The Treasury was given the authority to provide them with unlimited capital by purchasing their stock in order to keep them solvent. At this point, the government officially backed their debt securities and MBS guarantees. Under the conservatorship, both entities operate business as usual but with stronger backing for the holders of mortgage-backed securities (MBSs) and other debt. FHFA assumed the power of the board of directors and management. Common stock and preferred stock dividends were eliminated, but all common and preferred stock remains outstanding.

By 2009, the two GSEs owned or guaranteed approximately half of the outstanding mortgages in the country and financed almost 75% of all new mortgages that year. By the fall of 2011, the GSEs had provided more than \$5.7 trillion in funding for U.S. mortgage markets.

In July 2010, Fannie Mae and Freddie Mac were delisted from the New York Stock Exchange; they are currently traded in the over-the-counter (OTC) market. They are quoted on the OTC Bulletin under the symbols *FNMA* and *FMCC*. The Congressional Budget Office estimated that nearly \$400 billion in tax dollars would eventually be

needed to cover losses on the trillions of dollars' worth of mortgage-backed securities they own or guarantee.

As conservator of Fannie Mae and Freddie Mac, FHFA is taking aggressive steps in an effort to recover losses on both Fannie and Freddie loan portfolios. In July 2011, USB Americas was sued for making material misstatements and omissions about mortgage loans packaged under its private-label MBS. In September 2011, FHFA announced that it was suing 17 different financial institutions for misrepresenting the quality of mortgage-backed securities sold to Fannie or Freddie.

A major challenge for Congress over the next few years will be to develop a structure for the secondary mortgage market to achieve its original two purposes:

- Help ensure a steady supply of financing for residential mortgages.
- Provide subsidized assistance for mortgages on housing for low- and moderate-income families.

FHFA Actions

FHFA establishes the conforming loan limits and sets goals for the percentage of loans to be made to low- and moderate-income households each year. On October 24, 2011, changes to the Home Affordable Refinance Program (HARP) were announced that made the program available to more homeowners who were underwater in their mortgages. The program eliminated some risk-based fees, removed the current 125% loan-to-value ceiling, eliminated the need for a new appraisal, and extended the end date for HARP until December 31, 2013, for loans sold to Fannie Mae or Freddie Mac on or before May 31, 2009. HARP has now been extended through the end of 2015.

Under the terms of the Housing and Economic Recovery Act (HERA), the baseline limit for conforming loans must be adjusted each year to reflect changes in the national average home price, though the act prohibits any decline. Regardless of some ups and downs in average home prices between 2009 and 2014, the baseline limit remains at \$417,000 for one-unit properties in the contiguous United States. Loan limits are higher for multi-unit properties. In high-cost areas and in Alaska, Hawaii, Guam, and the U.S. Virgin Islands, the limit is 150% of the baseline limit. The local limit is based on 115% of the FHA median house price for an area, which is well below \$417,000 in most parts of the country. In no case can it exceed \$625,500 (150% of \$417,000).

The 2014 loan limits are shown in Figure 4.2.

FIGURE 4.2 2014 Conforming Loan Limits

	General	High Cost*
Single unit	\$417,000	\$625,500
Duplex	\$533,850	\$800,775
Triplex	\$645,300	\$967,950
Fourplex	\$801,950	\$1,202,925

*These high-cost limits also apply to Alaska, Hawaii, Guam, and the U.S. Virgin Islands. The loan limits are based on 115% of local median price established by FHFA up to the maximum limits shown above.

FANNIE MAE

Fannie Mae was established by congressional charter in 1938 as the Federal National Mortgage Association (FNMA) to expand the flow of available mortgage money throughout the country by creating a secondary market for the purchase of FHA-insured mortgages. The scope of operations was broadened in 1944 to include purchasing VA-guaranteed loans. The purchase of the FHA and VA loans was made at **par**; that is, at full face value, making Fannie Mae an important and sought-after provider for the real estate mortgage market.

Empowerment to Sell Mortgages

In 1954, Fannie Mae was rechartered as a national secondary mortgage market clearinghouse to be financed by private capital. Fannie Mae was empowered to sell its mortgages as well as purchase new FHA and VA loans. Fannie Mae's purchases were no longer made at par but at whatever discounted price would develop a reasonable rate of return. This profit attitude was consistent with the reorganizational goal of private ownership. Fannie Mae did not have to purchase every mortgage submitted to it, only those mortgages that met its standards for marketability.

In other words, Fannie Mae imposed its own criteria for acceptance of mortgages submitted for sale, which sometimes created animosity among mortgage originators. It was argued that one federal agency should accept another's standards. Fannie Mae countered with the argument that the FHA and VA standards for credit and appraisal were minimum standards and insisted that all mortgages submitted to Fannie Mae would have to meet its own standards for quality, yield, and risk. The quality and level of stability of guaranteed and insured loans were raised in order to meet these new requirements.

When Fannie Mae purchases mortgages, a servicing agreement is executed allowing the loan originator-seller to act as a collection agent for a specified fee. This fee, a rate of approximately one-fourth to three-eighths of 1% of the mortgage amount, creates a substantial source of income for the originator, depending on the size of its mortgage loan portfolio.

Loan originators derive a large portion of their mortgage investment income from origination and collection fees. In many cases, especially with the mortgage bankers who issue the bulk of FHA and VA loans, the more loans that can be created, the higher the potential profits. Thus, the Fannie Mae secondary mortgage market allows loan originators an opportunity to roll over their money. By selling their mortgages, these originators can secure more funds for making additional loans, thereby collecting more origination fees.

When Fannie Mae sells its mortgages, it does so in open-market transactions in which the purchasers are required to pay current prices for the securities.

Reorganization Under HUD

The Housing and Urban Development Act of 1968 changed the Fannie Mae organization once again. Based on its successful operation in preceding years as a quasi-public, profitable corporation, Fannie Mae was reorganized as a fully private corporation. All

Treasury-owned stock was redeemed, and a like amount of over-the-counter common stock was offered to the general public. Fannie Mae became a separate, privately owned corporation subject to federal corporate income tax and exempt from state income taxes. It retained the benefit of government sponsorship, which includes a line of credit with the U.S. Treasury, and was called a GSE.

The 1968 reorganization was meant to enhance Fannie Mae's ability to participate in the secondary market and to encourage new money to enter the real estate mortgage market. Fannie Mae could now purchase mortgages at a **premium** (in excess of par) and was allowed to expand its own borrowing ability by floating securities backed by specific pools of mortgages in its portfolio.

The Emergency Home Finance Act of 1970 gave Fannie Mae the additional authority to purchase mortgages other than FHA-insured or VA-guaranteed loans, mostly conventional loans. This further expanded Fannie Mae's impact on national real estate finance.

Administered Price System

In the past, Fannie Mae's mortgage-purchasing procedures had been handled under a free-market-system auction. Lenders offered to sell Fannie Mae their loans at acceptable discounts, with Fannie Mae buying the lowest-priced loans—those with the deepest discounts. This system was replaced by an **administered price system** in which Fannie Mae adjusted its required yields daily in accordance with market factors and its financial needs.

Under the administered price system, lenders call a special Fannie Mae rate line to secure current yield quotes and then a separate line to place an order to sell. Lenders may order a mandatory commitment whereby delivery of loans to Fannie Mae is guaranteed or a standby commitment in which the lender retains the option to deliver the loans or not, depending on the price at time of delivery.

Fannie Mae Mortgage-Backed Securities (MBSs)

When Fannie Mae purchases mortgage loans from mortgage companies, savings institutions, credit unions, or commercial banks, they are generally packaged into mortgage-backed securities (MBSs) and sold in international capital markets. In June 2005, Fannie Mae announced that first lien fixed-rate (and some adjustable-rate) mortgages for a term of up to 40 years would be eligible for inclusion in its MBS pools. Fannie Mae also issues a variety of short- and long-term debt securities to meet investor needs. The Universal Debt Facility Offering Circular is a legal document that provides detailed information on Fannie Mae's available Debt Securities: Benchmark Bills[®], Benchmark Bonds[®], and Benchmark Notes[®]. The Offering Circular clearly states that the securities are not guaranteed by nor constitute any debt or obligation of the United States.

For more detailed information, visit www.fanniemae.com and search for "Understanding Fannie Mae Debt."

Underwriting Standards

Lenders wishing to sell their conventional loans to Fannie Mae must subscribe to its guidelines, which are revised from time to time. Fannie Mae provides two versions of its automated underwriting system, the **Desktop Underwriter® (DU)** for lender servicers and the **Desktop Originator® (DO)** for independent mortgage broker-agents. Lenders access Fannie Mae's sophisticated loan analysis system through the software they offer customers. Selling Guides are available on www.efanniemae.com, along with a full guide to underwriting, which includes specific details on reporting borrower income and assets, debts and other liabilities, maximum interest rates, and loan amounts allowed for different types of loan products. After all of the borrower information is submitted to DU, a response is received with regard to both credit risk and eligibility for the loan. Ideally, the response will be approved/eligible.

Some Fannie Mae loan products require manual underwriting for loans that do not meet the guideline requirements as provided under automatic underwriting. The requirements for manual underwriting are also available online.

Typical Fannie Mae guidelines include the following:

- Any loan with a loan-to-value (LTV) ratio of more than 80% must carry private mortgage insurance; cost varies according to the amount of down payment and the borrower's credit history.
- A 20% down payment may be entirely from gift funds; gift funds are also permitted with less than 20% down, but 5% will be required from borrowers' own funds.
- The seller can contribute up to 3% of the sales price toward borrower's closing costs with a 5% down payment and up to 6% with a 10% down payment. (Six percent may be allowed on MyCommunityMortgage®.)
- Homebuyer Education and counseling is required for first-time homebuyers obtaining a MyCommunityMortgage®, those depending on non-traditional credit, or those purchasing a two-, three-, or four-unit property.
- Specific ratios for the total amount allowed for housing expenses (principle, interest, real estate taxes, property insurance, and any homeowner association or condominium fees) and for total monthly debt vary according to the type of loan product, but a conservative estimate would be 28% of gross monthly income (GMI) for housing and 36% of GMI for total debt, including housing expenses. The ratios are higher for special loan products such as the MyCommunityMortgage®.
- A minimum down payment of 5% is preferred, but there are still some loan products that only require a 3% down payment. A 2014 change now allows gifts and grants for a down payment.

Effective since 2011, a prospective borrower who has experienced a prior foreclosure may have to wait seven years before being eligible for a Fannie Mae loan. If the home was sold as a short sale where the bank accepted less than the total amount due, the waiting period is a minimum of two years. In the past, monthly debt like a car payment that would be paid off in less than ten months may not have counted as part of the total debt. As of 2014, all debt will be counted regardless of the months remaining.

See www.fanniemae.com for an eligibility matrix with information on both desktop and manual underwriting for fixed-rate and adjustable-rate mortgages plus HomeStyle Renovation®, Manufactured Housing, and MyCommunityMortgage®.

In Practice

A savings bank has just closed on \$5 million worth of home mortgage loans. The loans are all for 30 years at an interest rate of 8%. Although these loans will provide the bank with a steady stream of income for many years, the bank is now faced with a dilemma—no more funds available to make additional mortgage loans.

One way to achieve more capital would be to sell the mortgages to Fannie Mae or Freddie Mac. Of course, the bank would have to make sure that it followed the Fannie Mae/Freddie Mac guidelines with regard to the current maximum loan amount, down payment, qualifying ratios, seller contribution to purchaser's closing costs, and any private mortgage insurance requirements. As long as these guidelines are met, the \$5 million package of loans can be sold, though there will be a discount on the total. The bank can maintain the level of yield it desires, however, by passing along the discount to the borrowers in the form of discount points.

Conforming and Nonconforming Loans. The terms *conforming* and *nonconforming* are used by lenders to define loans that conform to the Fannie Mae/Freddie Mac qualifying guidelines. Loans that do not meet the conforming guidelines, including maximum loan amount and down payment requirements, are called **nonconforming loans**. Although there is a conforming loan limit, buyers may pay any price for a property, making up the difference in cash. Maximum loan limits are established to set a standard for these types of loans so that they become homogeneous packages for securitization in the secondary market. Loans issued in excess of these amounts are nonconforming. They are called **jumbo loans** and may be held by lenders for their own investment portfolios or sold to the secondary market. Any loan that does not meet all of the Fannie Mae/Freddie Mac guidelines is considered nonconforming, even though the loan amount may be very small.

Credit Scoring. Included in the automated underwriting process is the applicant's credit score, an objective method of assessing credit risk based on the statistical probability of repayment of the debt. The applicant's score is based on data included in the national repository files maintained by the credit bureaus Experian, Equifax, and TransUnion. The actual numerical score is derived from FICO scoring system.

Credit scores reflect the combination of many risk factors. In some instances, a borrower who has had a bankruptcy with an otherwise clean history of making payments may have a better credit score than another borrower who has not had a bankruptcy but has a long history of delinquent payments. A credit score of 620 to 680 may be acceptable with a larger down payment, but 720 is preferred for any LTV greater than 90%.

FICO and credit scoring will be discussed in greater detail in Chapter 9.

Establishing Non-Traditional Credit

Fair Isaac Credit Services, Inc., offers a FICO Expansion Score to assess credit risk. The secondary market has responded to this need by establishing guidelines for a Non-Traditional Mortgage Credit Report (NTMCR). Fannie Mae will only allow an NTMCR if a traditional credit score is not available from any of the three major credit repositories. Fannie Mae uses a three-tier approach for those unable to obtain a traditional credit score: Tier I credit includes rent, utilities, and telecommunication payments; Tier II includes direct insurance payments; and Tier III includes payments to local stores for durable goods, medical bill payments, and payments for school tuition or childcare. The goal is to obtain a 12-month history from four sources, preferably from Tier I. Freddie Mac has similar guidelines but includes union dues payments and regular payments to a savings or stock purchase plan.

Fannie Mae Mortgage Loan Products

Fannie Mae offers both fixed- and adjustable-rate mortgage loans in a variety of different loan products. For current information on mortgage loans eligible for purchase by Fannie Mae, visit www.fanniemae.com and www.efanniemae.com. Fannie Mae also purchases home construction and renovation loans as well as the FHA reverse mortgage for seniors called the Home Equity Conversion Mortgage. The 97% LTV Flexible Mortgage has been eliminated.

Fannie Mae offers a low-down-payment option for properties owned by Fannie Mae called the HomePath loan. The HomeStyle Renovation loan is for the purchase and cost of renovations with a down payment as low as 3%. It is available for the purchase of a primary residence, second home, or investment property.

Fannie Mae's MyCommunityMortgage[®] loans offer more flexibility in qualifying guidelines and credit history and have special options for teachers, police officers, firefighters, health care workers, and those with disabilities. There are also special loan products for rural housing and Native Americans.

See Fannie Mae's *Selling Guide*, available at www.fanniemae.com, for information on all Fannie Mae loan products.

FREDDIE MAC

The credit crunch of 1969 and 1970 gave rise to the Emergency Home Finance Act of 1970, which created, among other things, the Federal Home Loan Mortgage Corporation (FHLMC), now known as Freddie Mac. Freddie Mac was organized specifically to provide a secondary mortgage market for conventional loans originated by the savings associations and thrifts that are members of the Federal Home Loan Bank System.

Organization

Freddie Mac was established with an initial subscription of \$100 million from the 12 Federal Home Loan Banks and placed under the direction of three members of the Federal Home Loan Bank Board. Freddie Mac was given the authority to raise additional funds

by floating its own securities, which were backed by pools of its own mortgages. Since 1989, Freddie Mac has become an independent stock company and is a GSE like Fannie Mae.

As a major player in the secondary market, Freddie Mac buys mortgages that meet stated guidelines and product standards, packages the loans into **participation certificates (PCs)**, and sells the securities to investors on Wall Street.

As part of the Housing and Economic Recovery Act of 2008, Freddie Mac came under the supervision of FHFA and, in September 2008, was placed in conservatorship along with Fannie Mae.

Underwriting Standards

Freddie Mac generally follows the same conforming loan standards as Fannie Mae. One exception is that Freddie Mac only looks at total debt-to-income ratio with no set percentage for housing expense. The amount of down payment and qualifying ratios varies with different loan products.

Electronic Underwriting System. Freddie Mac provides its own automatic underwriting service, called **Loan Prospector**[®], to participating lenders, mortgage insurers, mortgage bankers and brokers, and others in the real estate market.

The Loan Prospector[®] software evaluates a borrower's creditworthiness using statistical models and judgmental rules. The credit evaluation indicates the level of underwriting and documentation necessary to determine the investment quality of a loan. It includes the borrower's credit reputation and financial capacity as well as the estimated value of the property. The credit analysis uses information from the loan application and credit searches. The value of the property is derived from statistical models or from a traditional appraisal.

Freddie Mac Loan Products

Freddie Mac purchases both fixed- and adjustable-rate loans for a predetermined amount of time from 15-year, 20-year, 30-year, and, in some cases, 40-year terms. Loans may be for the purchase or refinance of owner-occupied single-family dwellings, condominiums, planned unit developments (PUDs), and manufactured homes. Loans are also available for one- to four-unit primary residence and investment properties and single-unit second homes. As of September 2010, Freddie Mac no longer accepts interest-only mortgages.

Freddie Mac's Home Possible[®] mortgages offer a low down payment option for first-time and low- to moderate-income homebuyers and provide additional flexibility for teachers, firefighters, law enforcement officers, health care workers, and members of the U.S. armed forces. Homeownership education is required for first-time homebuyers using Home Possible mortgages. The debt-to-income ratio may be as high as 45%.

For a full description of the variety of loan products that can be purchased by Freddie Mac, see www.freddiemac.com.

Qualified Residential Mortgage (QRM)

The Consumer Financial Protection Bureau (CFPB) has been working on developing rules and regulations for establishing the **qualified residential mortgage (QRM)** program. Under this potential new program, a QRM would have a 20% down payment (no mortgage insurance), follow 28/36 income and debt ratios, and allow only borrowers with an above-average credit score. For any loan that doesn't meet QRM standards that is to be sold to Fannie Mae or Freddie Mac, the lender would have to retain a 5% interest in any mortgage securities.

After strong opposition from the National Association of REALTORS® (NAR), congressional leaders, and consumer and industry groups, the CFPB repropoed the QRM rule and aligned the definition of QRM with the same standards of a QM (qualified mortgage). The QM rule ensures that lenders only make loans to borrowers who have the ability to repay the loan. The QM rule prohibits loans with negative amortization, interest-only payments, balloon payments, terms of more than 30 years, and all “no doc” loans. Additional requirements are that points and fees paid by the consumer may not exceed 3% of the loan amount, and the debt-to-income ratio may not exceed 43%. No prepayment penalties are allowed.

There is a special provision regarding balloon-payment USDA loans in rural areas.

GINNIE MAE

The Government National Mortgage Corporation, known today as **Ginnie Mae**, was created in 1968 as a government-owned corporation under the direction of the Department of Housing and Urban Development (HUD) to provide financing for special assistance programs and operate the securities pool. Its stated mission is to expand affordable housing in America by linking domestic and global capital markets to the nation's housing markets.

Ginnie Mae does not buy or sell loans or issue MBSs but instead guarantees that investors will receive timely payments of principal and interest on MBSs backed by federally insured (FHA) or guaranteed (VA) loans. Other eligible loans for Ginnie Mae MBSs include those originated by the Department of Agriculture Rural and Community Housing (RHS) and HUD's Office of Native American Programs (ONAP). Ginnie Mae MBSs are fully modified pass-through securities guaranteed by the full faith and credit of the U.S. government. Regardless of whether the mortgage payment is made, the investor receives the full principal and interest payment.

Ginnie Mae Mortgage-Backed Securities

Mortgage-backed securities are pools of mortgages used as collateral for the issuance of securities, commonly called **pass-through certificates**, as the principal and interest payments are “passed through” to the investor. The interest on the security is lower than the interest rate on the loan to cover the cost of servicing and the guaranty fee. There are two types of Ginnie Mae MBSs available. The Ginnie Mae I MBS requires that all mortgages in the pool be the same type (e.g., single-family) and that the mortgages remain insured

or guaranteed by FHA, VA, RHS, or ONAP with a minimum pool size of \$1 million. Payment is made on the 15th of the month.

The Ginnie Mae II MBS provides for multiple-issue pools that allow for more geographic dispersal. Higher servicing fees are allowed, and the minimum pool size is \$250,000 for multilender pools and \$1 million for single-lender pools. Payment is made on the 20th of the month to allow time for payments to be consolidated by a central paying agent.

Ginnie Mae Platinum Securities. The Platinum Securities program allows investors to combine Ginnie Mae MBSs pools into a single security and receive one payment each month rather than separate payments from individual pools. See www.ginniemae.gov for more information on this program.

Ginnie Mae Real Estate Mortgage Investment Conduits (REMICs). Ginnie Mae administers a real estate mortgage investment conduits (REMICs) program. REMICs direct principal and interest payments from underlying mortgage-backed securities to classes with different principal balances, interest rates, average lives, prepayment characteristics, and final maturities. REMICs allow investors with different investment horizons, risk-reward preferences, and asset-liability management requirements to purchase MBSs tailored to their needs.

Unlike traditional pass-throughs, the principal and interest payments in REMICs are not passed through to investors pro rata; instead they are divided into varying payment streams to create classes with different expected maturities, differing levels of seniority, or subordination or other characteristics. The assets underlying REMIC securities can be either other MBSs or whole mortgage loans.

Ultimately, REMICs allow issuers to create securities with short, intermediate, and long-term maturities, flexibility that in turn allows issuers to expand the MBS market to fit the needs of a variety of investors.

FEDERAL HOME LOAN BANK (FHLB)

The 12 banks of the **Federal Home Loan Bank (FHLB)** system (referred to as FHLBanks) are owned by over 8,100 regulated financial institutions from all over the United States. Equity in the FHLBanks is held by the owner-members and is not publicly traded. FHLBanks are self-capitalizing and exempt from state and local income taxes but receive no direct taxpayer assistance. The mission of the FHLBanks is to provide cost-effective funding to the members for use in housing, community, and economic development; to provide regional affordable housing programs; to support housing finance through advances and mortgage programs; and to serve as a reliable source of liquidity for its membership.

As a government-sponsored enterprise (GSE), the FHLB is now regulated by the Federal Housing Finance Agency (FHFA). A major function of the FHLB is to provide its members a national market for their securities. The FHLB purchases loans from its member banks and provides strong competition in the secondary market. A recent update from the FHFA reports that the FHLBanks have emerged from the financial crisis in gen-

erally good condition. They are profitable and have strengthened capital positions with their 2012 annual earnings being their highest since 2007.

FARMER MAC

This program was originally created by Congress with the Agricultural Credit Act of 1987 as the Federal Agricultural Mortgage Corporation (FAMC). Known now as Farmer Mac, its mission is to improve the availability of long-term credit at stable interest rates to America's farmers; ranchers; and rural homeowners, businesses, and communities. This mission is accomplished by purchasing qualified loans from agricultural mortgage lenders, thus providing them with funding to make additional loans. Farmer Mac is the secondary market for agriculture loans in the same way that Fannie Mae and Freddie Mac are for conventional and government loans. See www.farmermac.com for more information on the program.

REAL ESTATE MORTGAGE INVESTMENT CONDUITS (REMICs)

Real estate mortgage investment conduits (REMICs) were established under the Tax Reform Act of 1986, and they are companies that hold pools of mortgages that back up securities collateralized by the mortgage cash flows. Mortgage-backed securities are broken into different classes called tranches, which direct principal and interest to predetermined groups of investors. REMICs are structures for the private securitization of real estate mortgages and contributed to the opening of the general capital markets to real estate lenders. Fannie Mae, Freddie Mac, and Ginnie Mae all offer REMIC multiclass, mortgage-backed securities.

REMICs offer several tax advantages that were not previously available on mortgage-backed securities. A REMIC may have various sources of income, but ownership comes in two categories: regular interests and residual interests. Regular interests are those offered to most investors. They are bond-like instruments with a face value equal to the share of the REMIC's underlying assets. Residual interests collect payments made in excess of those needed to pay the regular interests and any reserve funds set up initially.

A popular REMIC is the commercial mortgage-backed securities (CMBSs) pool. Prior to the development of this REMIC, commercial loan originators had no option but to keep these loans in their own portfolios. Very large loans were divided among several lenders. The CMBS industry continues to expand its participation in the U.S. mortgage loan market with over \$1 trillion securitization of commercial loans.

SUMMARY

This chapter examined the roles of the various major agencies involved in the secondary mortgage market for real estate finance, including Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Bank.

Based on electronic procedures that are uniform in the evaluation of credit and collateral, a huge market for trading in securities has evolved. Local originators of loans sell them to secondary investors, thereby freeing local capital for making more loans. In addition to FHA and VA loans, the secondary mortgage market has expanded to include conventional loans on homes, condominiums, multifamily projects, and commercial developments. Operating as warehouses of money, Fannie Mae and Freddie Mac effectively redistribute funds from money-rich areas to money-poor areas.

Fannie Mae was organized in 1938 as a federal agency involved primarily in purchasing and managing FHA-insured loans. The association evolved into a private, profit-making corporation dealing in every type of residential real estate mortgage loan. To raise funds for the purchase of these mortgages, Fannie Mae charges fees and has the authority to borrow from the U.S. Treasury. Fannie Mae markets its own securities. Freddie Mac was created in 1970 to provide a secondary mortgage market for the nation's savings associations. Through the years, it evolved into a private corporation, buying and selling all types of loans and adding to the effectiveness of the secondary market. As a result of the financial crisis that started in 2007, Fannie Mae and Freddie Mac were placed in conservatorship under the Federal Housing Finance Agency in 2008.

Created as a wholly owned government corporation in 1968, Ginnie Mae is under the jurisdiction of HUD. It finances special assistance programs and participates in the secondary market through its guarantee of FHA and VA mortgage-backed securities. In addition to the three major participants in the secondary market, other public and private agencies and companies have begun developing under the concept of collateralization. This concept pools existing mortgages together in homogeneous packages that are then pledged as collateral to issue mortgage-backed securities (MBSs). These MBSs are, in turn, sold to investors.

Additional secondary market participants are the Federal Home Loan Bank, Farmer Mac (which deals in farm and ranch loans), and the various real estate mortgage investment conduits (REMICs).

INTERNET RESOURCES

Fannie Mae

www.fanniemae.com

www.efanniemae.com

Federal Agricultural Mortgage Corporation

www.farmermac.com

Federal Home Loan Bank

www.fhlbanks.com

Federal Housing Finance Agency

www.fhfa.gov

FICO

www.fico.com

Freddie Mac
www.freddiemac.com

Ginnie Mae
www.ginniemae.gov

National Association of REALTORS®
www.realtor.org

REVIEW QUESTIONS

1. Fannie Mae and Freddie Mac are able to replenish their own funds, enabling them to purchase loans from primary lenders by
 - a. borrowing from the Federal Reserve bank.
 - b. borrowing from each other.
 - c. requesting grant funds through HUD.
 - d. selling mortgage-backed securities.
2. Lenders may order either a mandatory or standby commitment to sell loans to Fannie Mae through the
 - a. federal open market.
 - b. stock exchange.
 - c. free market auction.
 - d. administered price system.
3. Which of the following statements regarding Fannie Mae guidelines is *TRUE*?
 - a. Loans with a higher than 80% LTV require private mortgage insurance.
 - b. Maximum loan limits are set annually by each individual lender.
 - c. The seller may contribute up to 6% towards borrower's closing costs on all loans.
 - d. Homebuyer education and counseling is required of all borrowers.
4. The *BEST* description of a nonconforming loan is one that
 - a. exceeds loan limit set annually by Fannie Mae and Freddie Mac.
 - b. does not meet Fannie Mae and Freddie Mac qualifying guidelines.
 - c. is restricted to four-family units.
 - d. is limited to low-income housing.
5. All of the following are government-sponsored enterprises *EXCEPT*
 - a. Fannie Mae.
 - b. Freddie Mac.
 - c. Ginnie Mae.
 - d. the Federal Home Loan Bank.
6. Freddie Mac was originally chartered to
 - a. compete with Fannie Mae.
 - b. provide a secondary market for conventional loans (not FHA or VA).
 - c. purchase government loans.
 - d. provide mortgage loans for qualified applicants.
7. The agency established to ensure the financial safety and soundness of Fannie Mae and Freddie Mac is the
 - a. Federal Deposit Insurance Corporation (FDIC).
 - b. Office of Thrift Supervision (OTS).
 - c. Federal Reserve System (FED).
 - d. Federal Housing Finance Agency (FHFA).
8. The *MOST* important role played by Ginnie Mae today is
 - a. originating FHA loans.
 - b. purchasing VA loans.
 - c. oversight of Fannie Mae and Freddie Mac.
 - d. guaranteeing FHA and VA mortgage-backed securities.
9. The duties of the Federal Housing Finance Agency include all of the following *EXCEPT*
 - a. establishing conforming loan limits.
 - b. setting the percentage of loans to be made to low- and moderate-income borrowers.
 - c. regulating Fannie Mae and Freddie Mac.
 - d. supervising FHA.
10. The Tax Reform Act of 1986 established an entity that can issue multiclass securities. This entity, which has added to the activities of the secondary market, is the
 - a. REIT.
 - b. REMT.
 - c. REMIC.
 - d. RESPA.

Sources of Funds: Institutional, Non-Institutional, and Other Lenders

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- describe the types of loans offered by a commercial bank;
- explain the services of a mortgage broker and a mortgage banker;
- identify the various types of bonds used in real estate finance; and
- describe the role of private and foreign investors in real estate.

bearer bonds

correspondents

coupon bonds

debentures

demand deposits

fiduciary responsibility

financial intermediaries

general obligation bonds

industrial development bonds

industrial revenue bonds (IRBs)

interim financing

junior financing

mortgage bankers

mortgage brokers

mortgage revenue bonds

municipal bonds

origination fee

participation financing

real estate investment trust (REIT)

real estate mortgage trust (REMT)

registered bonds

revenue bonds

**Secure and Fair Enforcement
Mortgage Licensing Act (SAFE
Act)**

thrifts

warehouse of funds

zero-coupon bonds

Money available to finance real estate emanates from a long list of traditional and not so traditional lenders. The range of loan sources extends from the banks, thrifts, and life insurance companies, through the mortgage bankers and brokers to the private lending companies, and finally to the sellers who carry back loans to sell their own properties.

This chapter examines the following listed sources that make real estate loans. Collectively, they are called **primary lenders** or **financial intermediaries**. These lenders manage and guard entrusted funds over a period of time. The funds must be protected so they are available to their owners, dollar for dollar, when called for according to established arrangements. Because of certain characteristics, such as value, durability, and fixity, real property attracts much of this capital. Each of those listed will be described in detail, starting with institutional lenders, followed by non-institutional lenders:

Institutional Lenders

Commercial banks
Mutual savings banks
Savings associations/thrifts
Mortgage brokers
Mortgage bankers
Real estate trusts

Non-Institutional Lenders

Life insurance companies
Pension and retirement programs
Credit unions
Real estate bonds
Private lenders
Foreign lenders

COMMERCIAL BANKS

As the name implies, commercial banks are designed to be safe depositories and lenders for a multitude of commercial banking activities. Although they have other sources of capital, including savings, loans from other banks, and the equity invested by their owners, commercial banks rely mainly on **demand deposits**, better known as checking accounts, for their basic supply of funds.

Mortgage Loan Activities

Commercial banks were originally designed primarily to make loans to businesses to finance their operations and inventories. In more recent years, they often diversify into loans on real estate. In the past, they concentrated on industrial and commercial property real estate loans, but commercial banks are also active today in the one- to four-family home loan market.

Much of their real estate-related loan activities include construction loans, also known as **interim financing**; home improvement loans; and manufactured housing loans. These loans are all relatively short term and match the bank's demand deposit profile.

Construction loans run from three months to three years, depending on the size of the project. Home improvement loans may run up to five years and include financing the cost of additions, modernization, swimming pool construction, or other similar improvements. Manufactured home loans range from ten years to a longer term, usually depending on how permanently the home is attached to the property. These longer manufactured home loans usually include insurance from the Federal Housing Administration (FHA) or guarantees from the Department of Veterans Affairs (VA).

Today, most large commercial banks participate fully in home mortgages. Some of these loans may be kept in the bank's own portfolio, but most often the loans are packaged and sold in the secondary market to Fannie Mae, Freddie Mac, or other investors. Some smaller banks serve their select customers by providing them with long-term mortgage money on their homes. Other banks participate to some degree in the secondary money market by either selling home loans that they originate or buying packages of home loans to round out their own investment portfolios. Some commercial banks make loans to farmers for the purchase or modernization of their farms or for financing farm operations.

Other Bank Activities

Loans to borrowers based on the equity in their homes are a popular product for commercial banks. The Internal Revenue Service (IRS) eliminated tax deductions for interest paid on consumer loans but preserved the deductions for interest paid on home loans. As a result, banks compete vigorously for equity loan business. Borrowers may use the monies generated by equity loans to purchase personal property, pay for education expenses or vacations, and even buy additional real estate. Excesses in the creation of these equity loans, many known as subprime loans, contributed greatly to the recent financial crisis.

Commercial banks also participate in real estate financing through at least three other avenues: by operation of their trust departments; by acting as mortgage bankers (including the ownership of mortgage banking companies); and by direct or indirect ownership of other lending businesses.

Commercial banks' trust departments supervise and manage relatively large quantities of money and property for their beneficiaries. They act as executors or coexecutors of estates, as conservators of the estates of incompetent persons, as guardians of the estates of minors, as trustees under agreements entered into by individuals or companies for specific purposes, and as trustees under insurance proceeds trusts. They also act as escrow agents in the performance of specific escrow agreements; as trustees for corporations in controlling their bonds, notes, and stock certificates; and as trustees for company retirement or pension funds.

In keeping with their **fiduciary responsibilities** to obtain maximum yields at low risks, trust departments usually take a conservative approach when making investments with funds left in their control. The primary role of the trustees is to preserve the value of the property entrusted to their management. Real estate loans made from these trust accounts are only one possibility in a long list of investment opportunities.

In addition to acting as originating and servicing agents for their own mortgages, many commercial bank mortgage loan departments originate and service loans for other lenders. Acting in the role of mortgage bankers, commercial banks represent life insur-

ance companies, real estate investment or mortgage trusts, or even other commercial banks seeking loans in a specific community. In this capacity, a mortgage loan department secures an origination fee and a collection fee for servicing the new account, adding earnings to its overall profit picture.

Finally, some commercial banks participate, either directly or indirectly, as owners of real estate mortgage trusts (REMTs) or as members in a regional bank-holding company. These expanded investment opportunities add great flexibility to the real estate mortgage loan activities of commercial banks. Some larger banks make loans on commercial real estate developments, such as apartment projects, office buildings, or shopping centers. These larger loans usually are placed through bank-holding companies or subsidiary mortgage-banking operations.

Despite a movement toward the consolidation of banks, there is a countermovement of small bank start-ups. Many new small banks have been chartered, often organized by bankers who lost their jobs through mergers. These new banks seek business from the customers generally overlooked by the larger banks—small business owners, elderly depositors, and persons disenchanted with large bank anonymity.

The banking world continued to fight for the right to conduct general real estate brokerage up until March 11, 2009, when President Obama signed into law the FY2009 Omnibus Appropriations Act that permanently prohibits banks from entering the real estate brokerage and management businesses.

MUTUAL SAVINGS BANKS

Formed to provide savings services for the emerging class of thrifty workers in the U.S. industrial expansion of the mid-19th century, mutual savings banks are concentrated in the eastern United States. Although a few of these financial institutions are located in the states of Alaska, Oregon, and Washington, most are found in Connecticut, New York, and Massachusetts. Others are located in Delaware, Indiana, Maryland, Minnesota, New Jersey, Ohio, Pennsylvania, and Wisconsin.

These banks are organized as mutual companies in which depositors-owners receive profits as interest or dividends on savings accounts, and leading local business people make up the boards of directors. The boards maintain their integrity and continuity by controlling the appointments of new directors. They generally take a strongly conservative investment attitude, reflecting the safety requirements of their depositors.

Mutual savings banks play an active and important role in local real estate financing activities, providing long-term mortgage loans. This is a consequence of the nature of their organization, for these banks are actually savings institutions. More than 70% of their assets are derived from savings accounts, which by definition have a long-term quality.

Mutual savings banks prefer to make real estate loans on properties located near their home offices so that the loans can be supervised efficiently. In those instances where a bank's funds exceed local mortgage market demands, out-of-state mortgage outlets are sought, mostly through mortgage bankers.

Mutual savings banks generally are limited in their lending activities by their charters. These limitations vary from state to state and are also further affected by specific bank policies. Usually, only 60 to 70% of total savings deposits may be invested in real estate mortgages and then mostly within restricted lending boundaries and predominantly in residential properties. These area restrictions were originally imposed to ease loan servicing requirements, among other purposes. Although mutual savings banks play a relatively small role in actual dollar amounts in the total national real estate loan market, they do provide important local real estate loan support, and they were the prototype for the savings associations/thrifts.

SAVINGS ASSOCIATIONS/THRIFTS

Legend has it that the savings and loan associations, now known as savings banks or **thrifts**, were born when ten friends got together, each of them contributing \$1,000 to a pot. Each contributor then drew a number from a bowl, with number one having the use of the \$10,000 for a prescribed time period, then number two, and so on. This legend is not too far from the truth; early institutions were established as building and loan associations, with the specific purpose of providing loans to their depositors for housing construction.

In Practice

A local builder wishes to obtain financing to build six houses. He first checks with his own credit union—it is a fairly small credit union and they do not finance construction or home mortgage loans.

He then calls his insurance agent and finds that the agent is only interested in much larger projects—in which the insurance company might actually acquire some ownership interest. His own home mortgage loan is with a local savings bank, so he meets with a loan officer there. He finds that the savings bank would be interested in providing loans for the eventual buyers of the six properties, but the savings bank is not interested in construction financing.

The builder finally goes to a large commercial bank and is successful in acquiring a construction loan. In fact, the commercial bank offers him a construction/permanent loan product that will provide the construction financing now and guarantee the availability of permanent financing for the mortgage loans required by the buyers of the finished properties.

Thrifts are organized as either stock or mutual companies. Many mutual associations have converted to stock companies to attract more capital. These thrifts were relatively free from public regulation until the creation of the Federal Home Loan Bank (FHLB) System in 1932. Paralleling the Federal Reserve System for the commercial banks, the FHLB was chartered to regulate member organizations, determine their reserve requirements, set discount rates, and provide insurance for their depositors.

The FHLB operates the 12 district banks that are now regulated by the Federal Housing Finance Agency. The member savings associations were chartered and regulated by the Office of Thrift Supervision (OTS), which now falls under the Comptroller of the Currency (OCC). The accounts are insured up to \$250,000 per title per account by the Federal Deposit Insurance Corporation (FDIC).

All savings banks must be chartered, either by the OCC or by the state in which they are located. All federally chartered savings banks are required to participate in the FDIC insurance program.

Mortgage Lending Activities

Of all the financial institutions, the thrifts have the most flexibility in their mortgage lending operations. Although some limitations are imposed by federal or state regulations, savings banks can make conventional mortgage loans for up to 100% of a property's value. More commonly, though, the loans are based on an 80% loan-to-value ratio (LTV) with private mortgage insurance (PMI) required for any loan with higher than an 80% LTV. Any limitation on the area in which loans can be made has been virtually eliminated by the ability of savings banks to participate in the national mortgage market through Freddie Mac and Fannie Mae. The thrifts also participate in the FHA-VA loan market.

Paralleling the growing movement in small commercial bank start-ups was a marked increase in applications to the OTS for charters to operate new savings banks. The only way for companies that were not commercial banks to enter into the full service banking business was to secure a savings bank charter. This charter could be owned by any type of company, and a federal charter enabled the new savings bank to operate in all 50 states.

LIFE INSURANCE COMPANIES

Although the largest share of savings in the United States today is in securities and mutual funds, life insurance still plays a major role. According to the Department of Commerce, the insurance industry is one of the largest industries in terms of tax revenue on both the state and federal level. Insurance companies invest in municipal bonds, provide businesses with capital for research or expansion, and invest in commercial real estate.

Although there are no national laws concerning life insurance or casualty insurance companies, each state regulates these companies under their insurance departments. Life insurance and casualty companies can raise premium rates with permission from these state agencies, based on the amount needed to pay current claims and the earnings of the portfolio for future claims.

Life insurance companies are less concerned with the liquidity than with the safety and long-term stability of an investment. They prefer to finance larger real estate projects like shopping centers, leaving smaller loans such as home mortgages and construction financing to other lenders.

Many life insurance companies try to enhance the profitability and safety of their positions by insisting on equity positions in any major commercial project they finance. As a condition for such a loan, the company requires a partnership arrangement with the project developer. This type of financing is called **participation financing**, and it serves

to expand the life insurance companies' investment portfolios. Life insurance companies also purchase blocks of single-family mortgages or securities from the secondary mortgage market.

The continuing popularity of term insurance provides life insurance companies billions of dollars on which they do not pay dividends. This allows these companies to participate competitively in the real estate mortgage market, and life insurance companies play an indispensable role in providing funds for real estate developments.

PENSION AND RETIREMENT PROGRAMS

Monies held in pension funds are similar to the premiums collected and held by life insurance companies. Pension monies are collected routinely, usually from payroll deductions, and are held in trust until needed at retirement. They are not usually distributed in a lump sum but in regular payments, mostly on a monthly basis. This gives the pension fund managers a substantial amount of fixed funds together with a continuous flow of new monies. Over the last decade, a larger portion of U.S. savings have been in pension and other retirement programs.

Historically, pension monies were invested in government securities and corporate stocks and bonds, with little going into mortgage lending. Since the advent of the secondary mortgage market, pension fund managers have increasingly been purchasing blocks of mortgage-backed securities. The impact of this approach due to the economic crisis of 2007 is still to be determined.

CREDIT UNIONS

Federally chartered credit unions were originally authorized by President Roosevelt in 1934. Credit unions experienced years of tremendous growth after the National Credit Union Administration (NCUA) was created in 1970 as an independent federal agency to charter and supervise federal credit unions, and the National Credit Union Share Insurance Fund (NCUSIF) was established to insure credit union deposits. The NCUSIF was recapitalized in 1985 by requiring all credit unions to deposit 1% of their shares into the Share Insurance Fund, which was backed by the full faith and credit of the United States. Since that time, credit unions have continued to grow and provide their members with a source of funding for personal property such as autos or furniture, home improvements, home equity loans, and real estate.

As the insurer and regulator of federally chartered credit unions, the NCUA acts in a similar way to the FDIC with the ability to place a credit union in conservatorship. This became necessary several times during the financial crisis due to losses on investments in mortgage-backed securities.

As of July 2014, there are over 8,000 federally insured credit unions with government agency securities as the largest component of the industry's investment portfolio, the largest being the Navy Federal Credit Union based in Vienna, Virginia.

Under the Credit Union Membership Access Act, which became effective in January 1999, credit unions were allowed to solicit new members from much wider criteria. These changes have allowed small business groups to join credit unions, as well as any person who resides in a member's household, including unmarried couples, live-in housekeepers, nursing care professionals, or anyone who contributes support to the household. Moreover, all immediate family members may also be eligible to join, greatly expanding credit unions' growth.

Credit unions present competition to the banking industry. They generally are not governed by federal, state, or local banking regulations, providing them greater flexibility in making loans. Although credit unions specialize in personal property loans, they continue to expand their participation in real estate finance as they offer competitive interest rates and low loan placement fees. The credit unions are also involved in the secondary markets by pooling their mortgage loans into various real estate mortgage investment conduits (REMICs).

MORTGAGE BROKERS AND BANKERS

Financial intermediaries often lack the monetary capacity to expand beyond their local markets. When this occurs, these institutions look to the regional and national mortgage markets provided by Fannie Mae, Ginnie Mae, and Freddie Mac for expanded investment opportunities. These institutions also use the services of mortgage brokers and mortgage bankers.

Likewise, life insurance companies and pension fund managers enlist the aid of mortgage brokers or mortgage bankers to originate and service some of their real estate loans at the local level, rather than maintain an expensive network of branch offices.

Most lenders charge the borrower a placement or **origination fee** to cover the cost of creating the new loan—for the loan officer, processing, underwriting, closing, and all materials needed.

Mortgage Brokers

Much as stockbrokers or real estate brokers act to bring buyers and sellers together to complete a transaction for which the brokers are duly compensated, **mortgage brokers** join borrowers with lenders for real estate loans. The successful completion of the loan entitles the mortgage broker to earn a placement fee.

Unlike the major lenders, a mortgage broker seldom invests capital in a loan and does not service a loan beyond its placement. After a loan "marriage" is completed, specific arrangements are made for the collection of the required payments. Usually, these payments are made directly to the lender, but often they are collected by a local escrow collection service. The mortgage broker fulfills all obligations when the loan is completed.

It is important for mortgage brokers to assume a large part of the responsibility for qualifying borrowers and investigating the soundness of an investment. In fact, their very business lives depend on the quality of the loans recommended. A borrower seeking the services of a mortgage broker depends on the broker's access to the many institutions that

participate in real estate lending. A mortgage broker's success is a function of two things: (1) accessibility to the offices of the major real estate lenders and (2) the ability to "sell" the loan to these lenders. If the loan appears initially to be a poor risk, a broker would be destroying the broker's long-run effectiveness by recommending it.

The Association of Mortgage Professionals, formerly called the National Association of Mortgage Brokers, is the trade organization for this group. Emphasizing adherence to a strict code of ethics, this association promotes a full range of educational programs for its members. See www.namb.org for more information.

Mortgage Bankers

Many lenders seek to make real estate loans on properties located far from where they can personally supervise the loans. However, it is desirable to observe the physical condition of the collateral carefully, as well as to be available in the event of loan collection difficulties. Therefore, mortgage lenders, also called investors, seek the services of local intermediaries, called **mortgage bankers** or **correspondents**. These intermediaries not only originate new loans but also collect payments, periodically inspect the collateral involved, and supervise a foreclosure, if necessary. Mortgage bankers literally manage real estate loans.

Operation

Mortgage banking is not banking in the traditional sense. There are no tellers, cashiers, checking accounts, savings accounts, safe deposit boxes, or depositors. Some banks and bank holding companies own subsidiary mortgage banking companies to expand their latitude in creating and servicing their loans. Some larger companies are even going public, but most mortgage banking companies are privately owned. As private entrepreneurs, they derive income from fees received for originating and servicing real estate loans. The more loans they make, the greater their income. Therefore, mortgage bankers are under constant pressure to secure new business with which to earn substantial origination fees and increase service collection accounts.

Most mortgage bankers maintain a high community profile, taking active roles in social, political, and humanitarian efforts within their geographic regions. They also cultivate friendships with local land developers, builders, and real estate brokers to establish mutually beneficial associations. At the same time, most successful mortgage bankers develop a retinue of mortgage loan investment companies, which they represent in a specific locale. Thus, the mortgage banker assumes the role of an intermediary, searching out and developing new mortgage business, originating loans, selling the loans to investors, and collecting the payments on the loans for the benefit of the investors. Some of the larger mortgage banking companies maintain hazard insurance and escrow departments in addition to their loan origination and servicing divisions.

Although the mortgage banking industry is regulated under specific state laws, it is less regulated than banks because, in effect, mortgage bankers are not lending depositors' monies. Mortgage bankers often lend their own monies, or monies that they borrow from banks, to place new loans. These loans are then pooled into homogeneous packages that satisfy the requirements of specific loan investors as to loan amounts and property

locations. Such packages are then sold to these investors, while the mortgage banker retains the servicing contract.

Mortgage bankers are involved with every type of real estate loan. They can finance every stage of a real estate development—from providing funds to a developer to purchase, improve, subdivide the land, and construct buildings to providing the final, permanent long-term mortgages for individuals to buy these homes. In fact, a mortgage banker provides the expertise, money, and commitment necessary for the success of many real estate projects, both residential and commercial.

In Practice

A loan officer works for a lending company, which is a subsidiary of a savings bank. She is currently working with a young couple that is trying to purchase their first home. Unfortunately, they are deeply in debt and don't have the best credit.

However, the loan officer feels that there are some significant compensating factors that should make it possible for them to get their loan approved. Because she is a loan officer for the lending company, she is well aware of the qualifying standards required by the investor and will be able to work directly with the underwriter to try to make this loan work. If the loan officer worked for a company acting as a mortgage broker, she would not have such direct access to the source of funding for the loan and might not be as successful in working with the underwriter. On the other hand, as the mortgage banker is limited to its primary source of funding, there might not be as wide a range of programs available as there would be if the loan officer worked for a mortgage broker where she would be able to shop around to find a loan product that would fit the young couple's needs.

The mortgage banker's financial activities are based largely on the investors' commitments as to the quantity and required yields of mortgages to be placed in a particular community.

For example, a large life insurance company may want to invest \$50 million in multiunit apartment projects in a specific community. The company may specify a certain interest rate and also that no single mortgage may be less than \$10 million or more than \$20 million. Its representative mortgage banker would then seek to lend these funds on economically feasible projects to qualified borrowers. The mortgage banker must first negotiate, document, appraise, analyze, submit, and seek approval for a particular loan from the insurance company that, in turn, issues a mortgage commitment to the mortgage banker, who then issues a commitment to the developer.

The mortgage banker in this example typically might begin by making a commitment to a builder for a permanent loan on the apartment buildings to be built. This commitment would be based on the value of the property as estimated from the builder's plans and specifications. The banker would stipulate that a certain sum of money be loaned under the specific terms and conditions of payment, interest, and time.

On the strength of this commitment, the builder would be able to obtain a construction loan from a commercial bank. This construction loan would be repaid from the permanent loan proceeds when the project was completed. When the total of these loans

satisfied the \$50 million commitment of the insurance company, they would be sold as a package to this investor, who would then reimburse the mortgage banker, who would retain the servicing contracts.

Mortgage bankers often lack the financial capacity to lend the monies necessary to develop a package for their final investors because these investors will not send the mortgage banker any funds until the packages are accumulated. The mortgage banker will usually seek the aid of a commercial banker, who will, in turn, make a commitment to the mortgage banker to lend certain sums of money during the construction period until funds are received from the investors for mortgage settlements. This is called a **line of credit**. These short-term loans fit perfectly into the commercial banks' requirements, and, essentially, these banks become warehouses for mortgage money. Now the mortgage banker can draw down on the committed **warehouse of funds**, paying the commercial bank's interest requirement until the final funding from the investor satisfies the warehouse commitment. For example, the mortgage banker could borrow the monies from a commercial bank to close the loans with various borrowers until such time as the insurance company took delivery of the loans and funded them.

There is substantial and constant competition in the mortgage lending business. Depending to a great degree on the status of the money markets, the mortgage bankers compete with local savings banks, commercial banks, real estate investment trusts, and other mortgage bankers for a share of the market. The Mortgage Bankers Association (MBA) is active in promoting homebuyer education, often cooperating with local or state housing organizations. See www.mortgagebankers.org for more information.

The SAFE Act

The **Secure and Fair Enforcement Mortgage Licensing Act (SAFE Act)** was signed into law in 2008 as part of the Housing and Economic Recovery Act (HERA) and applies to all mortgage brokers and mortgage bankers. The SAFE Act was designed to provide more consumer protection and reduce fraud by encouraging states to establish minimum standards for the licensing and registration of state-licensed mortgage loan originators (MLOs). All mortgage loan originators were required to register with the Nationwide Mortgage and Licensing System and Registry (NMLSR) by July 29, 2011. The original standards for state licensing and registration were issued by HUD in June 2011, and responsibility for the SAFE Act was moved to the Consumer Financial Protection Bureau (CFPB) in July of that year.

Loan processors and underwriters are not subject to licensing requirements as long as they perform under the direction and supervision of a state-licensed and registered loan originator. A real estate professional who is only describing the terminology and the loan process is not subject to the SAFE Act requirement for licensure.

REAL ESTATE TRUSTS

Born under the provisions of the Real Estate Investment Trust Act of 1960, real estate trusts are designed to provide vehicles by which real estate investors can enjoy the special income tax benefits already granted to mutual funds and other regulated investment com-

panies. The earnings of regular corporations are taxed at the corporate level and then again at the individual level when distributed as dividends to stockholders. The real estate trusts have only a single tax, imposed at the beneficiary level. A **real estate investment trust (REIT)** is sold like stock on the major exchanges. Some REITs may invest in a particular type of property (such as a shopping mall); others may concentrate on a specific area of the country.

There are three types of REITs:

- Equity REIT: invests in real estate; income derived from rents or sale of property
- Mortgage REIT: lends money for mortgages or purchases mortgages or mortgage-backed securities; income derived from interest earned
- Hybrid REIT: combines equity REITs and mortgage REITs by investing in both property and mortgage

To qualify for the advantages of being a pass-through entity for U.S. corporate income tax, a real estate investment trust must

- be structured as a corporation, trust, or association;
- be managed by a board of directors or trustees;
- have transferable shares or certificates of interest;
- be taxable as a domestic corporation;
- not be a financial institution or insurance company;
- be jointly owned by 100 or more persons;
- have 95% of its income derived from dividends interest or property income;
- have no more than 50% of the shares held by five or fewer individuals during the last half of each taxable year (5/50 rule);
- have at least 75% of its total assets invested in real estate;
- derive at least 75% of its gross income from rents or mortgage interest;
- have no more than 20% of its assets invested in taxable REIT subsidiaries; and
- distribute at least 90% of its taxable income to shareholders annually in the form of dividends.

The value of a beneficiary interest in a real estate trust is a measurement of the profitability of that enterprise. If the trust is a successful entity, the beneficiaries profit accordingly. However, if the investment trust fails, the beneficiary's investments are lost. Thus, high risks ride in tandem with potentially high profit investments.

Equity REIT

Designed to deal in equities, equity REITs are owners of improved income properties, including apartments, office buildings, shopping centers, and industrial parks. As an

equity trust, the REIT can offer small investors opportunities to pool their monies to participate as owners of larger and, hopefully, more efficient and profitable real estate investments. The REIT's income is derived from two sources: (1) the net profits secured from its rental activities and (2) the capital gains made when these rental properties are sold. All profits are subject to income tax but only at the participant's level.

As REITs are designed as a form of mutual fund, they pass rental income directly through to shareholders with no tax imposed at the REIT level. In exchange for avoiding the double income taxes paid by business corporations and their stockholders, REITs are expected to be strictly passive investors.

Under the REIT Modernization Act (RMA) of 2001, the industry has been allowed to expand its earnings opportunities to include owning up to 100% of the stock of a normally taxable subsidiary company that can provide services to REIT tenants and others without disqualifying the rents that a REIT receives from its tenants. Thus, a REIT can now own companies that provide management and ancillary services for its buildings and tenants. REITs have grown to be a significant participant in the real estate market. They own over \$300 billion of investments, composed of office, retail, industrial, and hotel properties in addition to health care and specialty real estate. REIT yields are currently averaging around 6.18% annually. See www.reit.com for more information.

Mortgage REIT

More significant to mortgage lending are the **real estate mortgage trusts (REMTs)**. Attracting millions of dollars through the sale of beneficial shares, REMTs expand their financial bases with strong credit at their commercial banks and make mortgage loans on commercial income properties. Many of these are properties constructed for the investment portfolios of REITs. In fact, many REMTs are owned by either a parent company REIT or a commercial bank.

The REMTs' main sources of income are mortgage interest, loan origination fees, and profits earned from buying and selling mortgages. Although these trusts participate in long-term permanent financing, they are more inclined to invest in short-term senior and junior loans, where higher potential profits prevail.

Combination (Hybrid) Trusts

The combination or hybrid trusts join real estate equity investing with mortgage lending, thus earning profits from rental income and capital gains as well as mortgage interest and placement fees. REITs chartered today seek approval to invest in real estate and finance real estate.

Detailed information on real estate investment trusts can be found on the National Association of Investment Trusts website at www.reit.com.

REAL ESTATE BONDS

Bonds can be used to secure funds for financing real estate projects in two distinct ways. One is the issue and sale of mortgage bonds by business firms, usually corporations, to

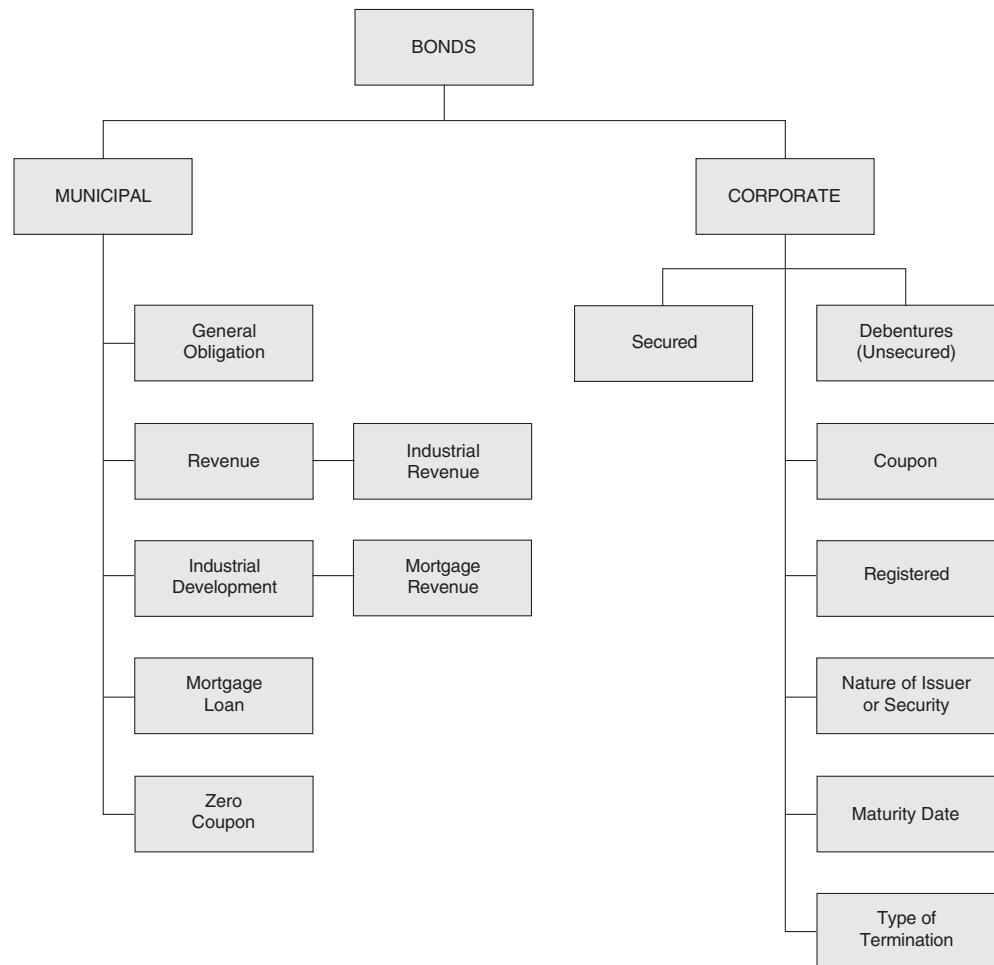
raise capital. The second is the issue and sale of bonds issued by states, local governments, school districts, and other forms of government to finance community improvements, such as schools, parks, bridges, hospitals, paving, sewers, and renewal projects. Bonds in the latter group are termed collectively **municipal bonds**. The interest paid on municipal bonds is exempt from all federal income tax and, in many cases, from state income taxes.

Figure 5.1 illustrates various types of bonds used in mortgage lending.

The administration of funds raised by a bond sale is left in the hands of a *trustee*, who acts as an intermediary between the borrower (issuer) and the bond owners (purchaser-lenders). The trustee supervises the collection of payments from the borrower and makes disbursements to the appropriate bondholders.

If the borrower defaults on a real estate bond, the trustee files a notice with the borrower that the entire balance and the interest are immediately due in full. At the same time, upon declaration that the borrower cannot or will not satisfy the debt, the trustee may enter the property, dispossess the borrower, and manage or sell it. All income or sales proceeds will apply to the benefit of the bond owners.

FIGURE 5.1 Bonds Used in Mortgage Lending



The Nature of Bonds

Corporate bonds are credit instruments used to raise long-term funds. When these bonds are backed by a mortgage on specifically described real property, they are called secured bonds. When a company issues bonds that are a claim against its general assets, they are called unsecured bonds or **debentures**.

Corporate bonds are also classified according to their method of payment. **Coupon bonds** have interest coupons attached, which are removed as they become due and are cashed by the bearer. Interest is paid to the person possessing the coupon, so these bonds are also called **bearer bonds**. **Registered bonds** are issued to a specific owner and cannot be transferred without the owner's endorsement. Under this form of bond, interest is paid to the last registered owner.

Bonds can be classified further as to the nature of the issuer—for instance, railroad bonds, industrial bonds, or corporate bonds. They are often described by the nature of their security, such as mortgage bonds, income bonds, or guaranteed bonds, or by their maturity date, as in long-term, short-term, or perpetual bonds. In addition, bonds may be classified by their type of termination—for instance, convertible, redeemable, serial, or sinking fund bonds. Finally, they may be classified by their purpose—for example, refunding, construction, equipment, or improvement bonds.

Corporate Bonds

The issue of corporate bonds to raise funds for real estate capital improvements, such as plant expansion or new equipment acquisition, is a relatively costly approach when compared to the use of mortgages. To float a new bond issue successfully, a corporation must secure the services of an investment banker or broker, print bonds (usually in \$1,000 denominations), and pay fees in advance to the appropriate regulating agencies as well as to the issuing brokerage house.

A large company could easily float a debenture or unsecured bond issue, while smaller companies would have difficulty even in issuing secured bonds. The investment broker is responsible for advising which bonds to market, what interest rates to pay, and what prices the bonds should have, according to specific money market conditions.

After the bonds are sold, their values fluctuate with the money market. For instance, if market interest rates rise, the value of the bonds issued at a lower interest rate decreases accordingly. To compete with higher market interest rates, the face value of these bonds would be discounted if the bond owner wished to sell them. The reverse is also true; when interest rates drop below those being paid on existing bonds, their value increases above their face amount. Bonds may be worth 95% of their face value at one time and 105% at another, depending on market conditions. Bonds are rated according to the financial security of their issuers. Investment rating services, such as Standard and Poor's and Moody's, constantly watch the major companies and report their financial conditions as they reflect on the companies' ability to pay their debts when due. Bonds with the highest ratings are considered by buyers to be safe investments and thus are not discounted to any major degree. Bonds with lower ratings usually are traded at greater discounts to reflect their higher risks.

Municipal and Private Bonds

A popular use for real estate bonds is to finance municipal improvement projects. By issuing **general obligation bonds**, guaranteed by the taxing power and the full faith and credit of the community, governments can raise funds for financing schools, street improvements, sewer installations, park developments, and other civic improvement projects.

A variation on this theme is the issue of **revenue bonds** to fund a specific community improvement project. These bonds will be repaid from the revenues generated by the improvements. For instance, a toll bridge could be constructed using the money raised from the sale of revenue bonds, and the repayment of the bonds would be designed to match the revenue secured from the tolls collected.

An illustration of the role of such revenue bonds in mortgage lending is their possible use in developing employment centers for a community. For instance, a city could float revenue bonds to develop an industrial park or construct buildings that might be leased to commercial tenants. These bonds are known as **industrial revenue bonds (IRBs)**. The rental income from the buildings would be adequate to repay the bonds over a long period of time. By this process new jobs are created, new taxes are generated, and generally an impetus of growth is infused into the community. Additional revenue bonds and other incentives can then be used by these growth-oriented communities to attract more businesses to their industrial parks.

Industrial Development Bonds

Unlike industrial revenue bonds, which are issued by a municipality for public improvements, **industrial development bonds** allow private investors an opportunity to finance apartment and commercial developments by using tax-exempt, and thus relatively inexpensive, funds. The developer prepares an application for approval by a local city or county Industrial Development Authority (IDA). This application includes the plans for the apartment or commercial development and a statement describing the need for these units to enhance the community's welfare. The bond attorney for the IDA reviews the application and makes a recommendation to the all-volunteer board.

If approval is secured, the developer hires a bond broker and floats a new issue. The interest rate is determined by the broker as a function of the market with the earnings exempted from federal, and often state, income taxes.

Mortgage Revenue Bonds

Mortgage revenue bonds are a form of industrial development bond. The bond issue is tax exempt because it is offered by state and local governments through their housing financing agencies. Use for the proceeds of the bond sales is limited to financing segments of the housing markets, such as low-income buyers, first-time buyers, and so on. Other limitations are imposed as well, such as the prices of homes eligible for participation in the bond program and the income of the borrowers.

The government agency transfers the proceeds of the bond sale to the lender, who then makes a mortgage loan to the developer of the project. Because of the tax exemption on income derived by the bondholders, interest to the borrower is lower than market

rates, and rents can be lowered accordingly. In addition, 20% of the units must be allocated for low-income renters for ten years or half the life of the loan, whichever is longer.

A significant portion of the senior housing market, assisted-living care facilities, can now be financed with tax-exempt revenue bonds so long as the project does not provide continual or frequent medical or nursing services according to IRS rule 98-47. The ruling states that these are residential rental properties and eligible for the bonding finance.

Zero-Coupon Bonds

Zero-coupon bonds represent an old approach to bond buying. They are patterned after World War II savings bonds, which were sold for \$18.75 and redeemed after ten years for \$25. A buyer writes a check for a bond at a discounted price and holds this bond until maturity or until it is sold, with interest compounding regularly. Interest must be reported each year for tax purposes even though it is not collectible until the bond matures.

Mortgage Loan Bonds

Some states issue income-tax-free bonds to secure funds for relatively low-cost mortgage loans. These loans are available to eligible persons to help them acquire houses and condominium units. The interest income from these bonds is tax exempt at both the federal and state levels, so their purchasers can buy them at lower rates than would be required on taxable investments. These savings are passed along to the borrowers, who will pay slightly higher interest rates on their loans than are paid to the bondholders to cover operational costs.

PRIVATE LENDERS

Another group of lenders that provides funds for mortgage lending is the private lenders. This group includes individuals and private loan companies. Little data is available about the impact of these private lenders on the overall realty money market because of the privacy of the participants' transactions. Because these lenders invest their own funds, they owe no duty to others and can maintain complete discretion over their activities.

Despite this comparative freedom, most lenders observe conservative limitations. No one invests to lose money, and good underwriting procedures are followed. In the entire field of real estate lending, these private lenders have the most flexibility and can take the most risks. This often makes them the only source of funds for certain real estate projects.

Individuals

When other financing is not available, the sellers of property often have to provide the funds to close the deal. Arrangements for seller financing are usually made in the negotiations directly between the buyer and seller.

Sellers as Lenders

The single most important source of private finance funds consists of the sellers who finance a portion of the sales price with carryback loans. In fact, seller financing has become the only way some sales can be consummated. Using junior loans, contracts for deed, wraparounds, and other creative financing devices (described in later chapters), sellers often help finance a portion of a property's sales price.

Some loans made directly between buyers/borrowers and sellers/lenders involve first mortgages. For instance, when the property being sold is held free and clear of any debt, the seller might agree to carry back a new first mortgage from the buyer for most of the purchase price. However, if a house is selling for \$180,000 and the current balance on the existing mortgage is \$140,000, the seller might agree to carry back \$20,000 of the \$40,000 equity as a second mortgage if the buyer agrees to pay \$20,000 as a cash down payment. Most individual financial agreements involve junior financing where the seller carries back a portion of the equity in the property.

Sellers agreeing to carry back a portion of their equity as a junior loan subject to an existing senior loan must be aware of the risk that the buyers may not keep up the payments on the senior loan. This would put the sellers in jeopardy of losing their junior loan equity. To offset this risk, a collection escrow could be established at the time of the sale where the buyers would send both the senior and junior loan payments to the collection agent with directions for immediate notification to the sellers if these payments are not forthcoming.

Family Members as Lenders

Homebuyers, especially those with small children, may find they do not have the funds necessary to meet down payment requirements. They may look to their parents or other family members for help. Under these circumstances, a letter from the donors indicating the amount of the gift is delivered to the loan officer who is preparing the new loan package. In some cases, the donors are required to cosign the mortgage documents in order to include their own financial resources as additional collateral.

These arrangements often can be established as partnerships in which the parents, as co-owners, make the down payment and the children agree to make all the monthly payments on the mortgage. If the property is refinanced or sold in the future, the partners will share in the proceeds.

Based on current law, anyone can make an annual tax-free gift of up to \$13,000 to any individual. A married couple could present up to \$52,000 in tax-free gifts every year to their two children (\$13,000 from each parent to each child).

Private Loan Companies

Private loan companies range from the large national company with branches in almost every city to the individual entrepreneur who may personally buy and sell loans. These private lenders deal primarily in **junior financing** arrangements that use a borrower's equity in real property as collateral. These companies make loans from their own funds or monies borrowed from their commercial banks, act as mortgage brokers in arranging loans between other lenders and borrowers, and buy and sell junior financing instru-

ments, usually at a discount. In this latter capacity, these private loan companies help create a secondary market for junior loans.

Private real estate loan companies usually charge more than other lenders. They attempt to offset the risks inherent in their junior lien position by charging the maximum interest rates allowable by law and imposing high loan placement fees. Many states have developed laws regulating the activities of private lenders. Besides requiring loan companies to obtain licenses and performance bonds, some states limit the amount of fees that these lenders can charge for their services.

FOREIGN LENDERS

The United States has been considered safe for foreign investment for many years. At any given time, there may be billions in foreign monies deposited in U.S. commercial banks. Short-term funds have little impact on mortgage lending, although funds left on deposit for relatively long periods of time can have an effect on the monies available for mortgage lending. Foreign investors also bought heavily into mortgage-backed securities, which caused serious problems as a result of the financial crisis of 2008.

As many countries throughout the world teeter on the brink of financial collapse, the United States still attracts foreign money. On June 20, 2011, the *Chicago Tribune* reported that foreign investment in the United States had risen 49% in 2010 over the previous year. Over 90% of that investment came from Canada, Europe, and Japan, with less than 1% from China. However, the *New York Times* reported in July 2011 that Chinese investment rose to \$5 billion in 2010, with the anticipation of over a trillion more in this decade. FoxBusiness reports over \$14 billion in 2013. A direct impact on real estate can be seen in New York City, where Chinese investors have poured billions into real estate development. These investors are buying luxury apartments and investing in commercial and residential projects throughout the city. The latest data from the National Association of REALTORS® shows that foreign buyers purchased over \$68 billion of single-family homes in the United States in the year ending March 2013—about 7% of the total U.S. market. The fastest growth was buyers from China and Canada, and the majority of purchases were in Arizona, California, Florida, New York, and Texas.

SUMMARY

The major financial intermediaries are commercial banks, mutual savings banks, savings associations or thrifts, life insurance companies, pension and retirement funds, and credit unions. They usually display conservative investment attitudes compatible with their roles as guardians and protectors of their depositors' and premium payers' money.

Commercial banks have traditionally participated in real estate finance mainly as short-term lenders, preferring to maintain their liquidity while at the same time maximizing their earnings by trading in commercial paper. Through their mortgage loan departments, however, commercial banks have become very active in the home mortgage loan market in addition to construction loans, home improvement loans, and manufactured

home mortgages—all relatively short-term investments. In addition, through their trust departments, mortgage banking facilities, and ownership of real estate investment trusts, commercial banks participate to some degree in long-term real estate investments.

Mutual savings banks are designed to participate extensively in local realty mortgage markets. Because savings by definition have a long-term nature, these institutions are able to make long-term loans, predominantly in real estate finance.

Savings banks engage actively in owner-occupied, single-family residential mortgages. Some savings banks also participate in regional and national mortgage markets by buying and selling blocks of securities from and to the secondary market.

Life insurance companies accumulate large reservoirs of monies to be held for long periods of time. Their real estate investments complement this profile and include the larger mortgages on major national commercial and industrial real estate developments. Although life insurance companies invest only a portion of their total assets in real estate finance, the huge dollar amounts of these assets make their contribution to real estate financing and the success of large-scale construction projects significant.

Pension and retirement funds have substantially increased their assets in recent years and have the potential to become a major source of mortgage lending. In the past, however, pension funds have mostly been invested in government and corporate securities.

Another type of financial intermediary that participates to an increasing degree in mortgage lending is the credit union. Although involved primarily in financing members' personal property purchases, many credit unions are now financing equity loans and first mortgages.

Mortgage brokers act as catalysts in the process of matching borrowers and lenders, a service for which they earn a finder's fee. Fees on residential loans are related to an origination fee and compensation for the servicing of the loan. Fees on commercial loans are related to the time and effort expended in the loan's successful presentation. Once a loan has been finalized, the broker's responsibilities are usually completed.

Mortgage bankers, on the other hand, not only generate new mortgage loans between the major fiduciary lenders and individual borrowers but continue to function as intermediaries. They collect mortgage payments, inspect the condition of collateral, counsel delinquent borrowers, and foreclose when necessary. In addition, mortgage bankers often invest their own funds or borrow money from their banks to finance site acquisitions, land improvements, construction costs, and permanent mortgages in order to complete a full development program. The real estate trusts, much like the stock market's mutual funds, are depositories for small investors who pool their monies for greater investment flexibility. The investors take a passive role in management and allow the trust's directors to decide on the investment policy.

Some real estate trusts are involved exclusively in equity holdings. These equity trusts are described as real estate investment trusts (REITs), and they purchase property for its income and potential growth in value. Other real estate trusts, defined as real estate mortgage trusts (REMTs), invest primarily in real estate mortgage loans. Some real estate trusts are hybrids that combine equity participation and mortgage investments.

The issue and sale of real estate bonds is an additional source of funds for mortgage lending. Corporations issue bonds to secure money for plant expansion, equipment purchases, and operational expenses. Various governmental bodies may issue bonds to raise

funds for improvements, such as schools, parks, streets, industrial developments, bridges, hospitals, and sewage plants. The administration of funds raised by a bond sale is left in the hands of a trustee, who supervises the collection of payments from the borrower-issuer and the distribution of dividends to the investors/purchasers.

Private lenders often provide the funds required to close many real estate transactions. Without their ability to make independent decisions and take extra risks, many real estate transactions would be impossible to complete.

Foreign investment into the general economy has been increasing, especially from China. These investments are directly impacting real estate development in New York City.

INTERNET RESOURCES

Mortgage Bankers Association

www.mortgagebankers.org

The Association of Mortgage Professionals

www.namb.org

National Association of Real Estate Investment Trusts

www.reit.org

National Credit Union Administration

www.ncua.gov

REVIEW QUESTIONS

1. What is the main source of capital for the supply of funds needed by a commercial bank?
 - a. Interbank loans
 - b. Savings accounts
 - c. Federal Reserve deposits
 - d. Checking accounts
2. All of the following are usually short-term mortgage loans *EXCEPT*
 - a. construction loans.
 - b. home improvement loans.
 - c. single-family home loans.
 - d. manufactured home loans.
3. A local builder wishes to obtain financing to build four houses. His *BEST* source would be a
 - a. savings association.
 - b. commercial bank.
 - c. credit union.
 - d. life insurance company.
4. Mutual savings banks are located primarily in the
 - a. West.
 - b. Northeast.
 - c. Midwest.
 - d. South.
5. Which is *NOT* a prominent role of life insurance companies in real estate?
 - a. Purchasing blocks of mortgages on the secondary market
 - b. Financing large commercial projects like office buildings or shopping centers
 - c. Originating individual home mortgage loans
 - d. Financing major industrial projects
6. A mortgage broker may do all *EXCEPT*
 - a. receive a placement fee.
 - b. service the loan.
 - c. investigate soundness of the investment.
 - d. bring together the borrower and the lender.
7. A couple has applied for a mortgage loan. The loan officer will prequalify the couple, match them with an appropriate loan product, carry their case through to loan approval, and continue to service the loan. The loan officer's company is a
 - a. mortgage banker.
 - b. mortgage broker.
 - c. financial fiduciary.
 - d. financial investor.
8. A mortgage company is preparing a package of loans for sale to an investor. In order to have adequate funds to originate the number of loans required by the investor, the company may need to establish a line of credit with a local commercial bank. This is called
 - a. warehousing.
 - b. direct deposit lending.
 - c. participation financing.
 - d. correspondents.
9. An individual has invested in a real estate trust that will derive income using the net profits from rent and sale of rental properties. He has invested in a
 - a. REIT.
 - b. REMT.
 - c. hybrid.
 - d. joint venture.
10. An individual has invested in a real estate trust deriving income from mortgage interest, loan fees, and profits from buying and selling mortgages. She has invested in a
 - a. REIT.
 - b. REMT.
 - c. hybrid.
 - d. joint venture.
11. A county is issuing bonds for sale to fund a new consolidated high school. These bonds are termed
 - a. corporate bonds.
 - b. trustee bonds.
 - c. municipal bonds.
 - d. debentures.

12. A woman recently lost a briefcase containing several different types of bonds. She is very concerned that someone finding the briefcase will be able to cash in her bonds. She need *NOT* be concerned if the bonds are
- coupon bonds.
 - bearer bonds.
 - registered bonds.
 - unsecured bonds.
13. Which is *TRUE* regarding the value of a bond?
- The value never changes throughout the term of the bond.
 - The value is guaranteed to increase over the term of the bond.
 - The value will fluctuate with the money market.
 - The value is established by Standard and Poor's rating service.
14. The *MOST* significant feature of a REIT is its
- ownership by at least five investors.
 - continuous growth in value.
 - elimination of double taxes.
 - fiduciary relationship to its investors.

Instruments of Real Estate Finance

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- give examples of encumbrances and liens on a property;
- compare a mortgage and a deed of trust;
- discuss the possible uses for a contract for deed and precautions that should be taken;
- describe a junior loan used as a home equity loan and how it may be used; and
- identify special clauses that may be used in mortgage lending instruments.

acceleration clause

assumed

beneficiary

carryback loan

contract for deed

cross-defaulting clause

deed of trust

defeasance clause

due-on-sale clause

encumbrance

equitable right of redemption

equity loan

exculpatory clause

granting clause

involuntary lien

lien theory

lifting clause

mortgagee

mortgagor

nonrecourse clause

note

note and mortgage

novation

power of sale

prepayment clause

release clause

second mortgage

subject to

subordination

title theory

trust deed

trustee

trustor

usury

vendee

vendor

voluntary lien

Although many aspects of mortgage lending change frequently, the instruments for executing a real estate loan have remained basically the same. This chapter reviews the broad legal aspects of pledging real estate as collateral for a loan, and it examines the form and content of the three instruments used to finance real estate. Each state may have its own statutes stipulating the form and content of these instruments. The actual financing documents are usually prepared by the lender; the deed conveying interest in the property is prepared by the settlement attorney or agent.

This chapter examines a number of special provisions that can be included in financing instruments to serve the needs of both borrowers and lenders. The final section reviews the instruments used to establish junior financing relationships.

ENCUMBRANCES AND LIENS

An **encumbrance** is a right or interest in a property held by one who is not the legal owner of the property. Encumbrances that affect the physical condition of a property may be imposed on a parcel of land without destroying the owner's estate. These physical encumbrances do not prevent the owner from using the property or transferring it. Encumbrances of this type include easements, public and private restrictions, and encroachments.

Almost every parcel of real property has some form of physical encumbrance imposed on it. The most common is the utility easement that provides the accessibility, both under and over the land, for the installation of water, gas, electric, telephone, and sewer services. These easements are recorded agreements between the property owner, usually the original subdivider, and the appropriate agency responsible for the services indicated. These recorded physical encumbrances become "covenants that run with the land" and follow the title through its various owners.

A property's title may also be affected by a financial encumbrance called a lien. A lien is a charge against a specific property where the property is made the security for the performance of a certain act, usually the repayment of a debt. Thus, deeds of trust, mortgages, and contracts for deed are all forms of liens.

Unlike physical encumbrances, liens are personal in quality, relating owners' economic situations with their real property. Liens can be either **voluntary liens**, such as financing instruments, or **involuntary liens** imposed by law, such as liens for taxes or assessments, mechanics' (construction) liens, and judgment liens. General liens apply to all nonexempt property, while specific liens apply only to a single property of the debtor.

In Practice

A married couple is purchasing their first house for \$150,000. They are making a down payment of \$15,000 with a mortgage loan of \$135,000. The mortgage establishes a financial encumbrance on the property. This encumbrance is called a *lien*. Prior to settlement, they are informed by the title company handling the closing that there are several other encumbrances on the property:

- The local electric utility company has an easement across the front edge of the property where they have power lines buried that serve that entire block.
- The homeowners association has restrictions against any fencing in the front yard of the house.
- The next-door neighbor's fence is encroaching on the property by four inches on one side of the property.

Should any of these be of concern to the couple? The title company agent explains that the electric company's gross easement and the homeowners association's private restriction are covenants that run with the land; in other words, they have been previously granted and automatically transfer along with the conveyance of the property. The question of the neighbor's fence encroaching on their property will probably need to be resolved before title insurance will be issued.

A mortgage loan secured by a parcel of real estate becomes a specific voluntary lien against the subject property at the time it is recorded at the courthouse of the county where the property is located. Deeds of trust, mortgages, and contracts for deed will be signed by all appropriate parties, acknowledged by a notary, and usually recorded. This recording process is designed to give public notice that a lender has certain lien rights in the property described in the loan instrument.

Lenders' rights are invariably superior to the rights of other subsequently recorded lienholders, with certain special exceptions. These exceptions include the specific liens imposed by local or state governments for nonpayment of property taxes. Otherwise, based on the doctrine of "first in time, first in right," lenders establish a priority lien position on the date their loan document is recorded. In the event of a foreclosure and sale of the collateral, the proceeds of the sale are distributed per the priority of the liens existing against the subject property. Lenders whose loans have the earliest recording dates are said to be in senior lien positions, and their rights take priority over those of all subsequent lienholders.

LOAN SECURED BY A REAL ESTATE INTEREST

Any interest in real property can be security for a real estate loan. Most common to real estate finance is the pledge of a fee simple ownership as collateral to back up a promise to repay a money debt. Real property can also be pledged as collateral to secure financial lines of credit or ensure the specific performance of a contract. Fee simple ownership can

be enjoyed by individuals, corporations, and various forms of partnerships. Individuals, their assigns, and their heirs can pledge their titles and interests in real estate in exchange for loans. Corporations, as legally created entities, may own real property and can pledge it as collateral for financing purposes. Likewise, various combinations of individuals and corporations that have joined into partnerships to own real properties can pledge their interests in these properties in order to borrow money.

Less-than-freehold interests, such as rental income from property or the leasehold rights of a tenant, can also be used as collateral for a loan. The parties to a life estate can pledge their interests for loans, even though these interests are not fully vested when the loan is secured. Most lenders are aware of the risks involved with such loans.

Other interests in real property can be owned independently from the land itself. Rights to the use of the airspace over a parcel of property fall into this latter category, as do the rights to the use of water and the extraction of oil and minerals from the earth. These rights can be pledged as collateral for a loan, either singly, collectively, or jointly with other properties.

In some instances, personal property is required as additional security to real property pledged as collateral for a loan. Thus, loans for houses might include furnishings as collateral, in addition to the real estate. Commercial property loans might include trade fixtures as mortgage loan collateral.

Title, Lien, and Intermediate Theories

Originally, most real estate loans were designed to allow the lender to take actual physical possession of the land until the principal sum of the loan and any agreed-upon interest was obtained from the proceeds of the land's production. For all intents and purposes, the lender was the owner of the land until the debt was satisfied, at which time ownership and possession were returned to the borrower. Simply put, the lender held title to the collateral.

As the system evolved, the procedure was changed to allow borrowers to remain in possession of the land, so long as they kept the terms of the loan agreement. However, the borrower was still required to transfer legal ownership to the lender by placing title to the property in the lender's name. Thus, the lender secured legal title, and the borrower retained equitable rights in the property.

Concern about who held title to collateral property stemmed from lender demand for guarantee of the return of funds loaned or, at least, a property with value adequate to substitute for funds lost. Here the rights of a lender were superior to the rights of a borrower. The lender could dispossess the borrower without notice at the first default of the loan agreement. No compensation was made for any monies already paid to the lender. This concept has evolved into the **title theory** of mortgage lending, which has been adopted in some states.

As time progressed, the laws were modified to reflect the borrower's legal right to redeem property within some reasonable time after default. This right, called an **equitable right of redemption**, gave defaulting borrowers time to protect their interests, but it ceased when the property was sold at a foreclosure sale.

To complement these equitable redemption rights, more than half the states have adopted periods for redemption after the foreclosure sale. These statutory periods of redemption vary from three months to two years, depending on the state.

Through the years, the competition between lenders' and borrowers' rights has shifted dramatically to borrowers. Most states have adopted the **lien theory**, which recognizes the rights of lenders in collateral property as equitable rights, while borrowers retain their legal rights in their property. Thus, a borrower maintains legal interest in property while pledging it as collateral to a lender who acquires a lien, or an equitable interest, in the collateral property in return for the funds lent. In effect, the lien theory allows a defaulted borrower to retain possession, title, and all legal rights in the property until the lender perfects the lien against the collateral property, according to legal foreclosure procedures that recognize the borrower's redemption rights. This theory shows quite a shift in the priority of rights.

However, just as excessive power gave rise to abuses by lenders prior to the development of equity of redemption, lien theory, when coupled with the concept of statutory redemption, provides the opportunity for borrowers to become abusive. Whereas lenders previously were able to dispossess their borrowers arbitrarily, now defaulted borrowers are often able to remain in possession of their properties for long periods of time without making loan payments. Longer statutory redemption periods have resulted in endless problems for lenders trying to recover their collateral and minimize their losses within a reasonable time.

Therefore, some states have taken a modified position between the title and lien theories. This intermediate position allows a lender to take possession of collateral property in the event of a loan default, often without having to wait until foreclosure proceedings have resulted in a possessory judgment. However, the lender does not receive title until after the expiration of statutory redemption periods prescribed by law.

General Requirements for a Finance Instrument

Regardless of the theory practiced in a particular state, all borrowers and lenders throughout the United States must observe the same general requirements to protect their rights when making a loan transaction. Real estate loans are contractual agreements that must contain certain basic elements to be valid. All terms of the loan transaction must be formalized in writing. They must include accurate descriptions of the interest and property being pledged as collateral and a complete statement detailing the loan repayment. The parties to the agreement must be legally competent; their consent must be indicated by their signatures, properly attested and affixed to the loan agreement, and a sufficient consideration must be paid.

The three basic instruments used to finance real estate—the note and deed of trust, the note and mortgage, and the contract for deed—all share the requirements listed previously, but each has its own unique form and content.

THE NOTE AND DEED OF TRUST (TRUST DEED)

A trust is described as a right of property, real or personal, being held by one party for the benefit of another. The parties to a trust include a **trustor**, who grants rights to a **trustee**, who holds the property in trust for a **beneficiary**. In all cases involving the establishment of a real estate trust, an instrument called a **trust deed** is executed by the trustor in order to transfer legal fee ownership, to be held for the beneficiary, in the name of the trustee. Note: The trustee and the beneficiary may sometimes be the same person/entity.

When a trust deed is used for financing real estate, it is called a **deed of trust**. The lender/beneficiary usually selects a trustee who secures title to the collateral from the trustor/borrower as well as the power to foreclose if necessary.

In title theory states, a deed of trust transfers the title of the collateral to the name of a third-party trustee, who retains this “ownership” position until the terms of the loan are satisfied. In lien and intermediate theory states, title remains with the borrower (trustor), and the trustee acquires only lien rights. If the loan goes into default, the trustee is empowered to foreclose on the collateral property. These foreclosure powers are described in Chapter 10.

Note Used with a Deed of Trust

The **note** that accompanies a deed of trust includes the borrower’s promise to pay the lender a designated sum under the terms and conditions specified. It also refers to the security of a specific deed of trust given to the trustee as collateral for the loan.

In the event of a default under a note for a deed of trust, borrowers have assigned their defenses to the automatic action of the laws governing foreclosure of the debt instrument, known as the **power of sale**. This gives lenders the opportunity to secure more readily full legal title to the collateral, even when borrowers abandon their property and disappear. However, borrowers’ rights are still protected by law. Lenders are required to give adequate notice to borrowers and allow them an appropriate period in which to redeem their property. This increased foreclosure power is the distinguishing feature between the deed of trust and the mortgage.

A note for a deed of trust must be signed by the borrowers and accepted by the trustees, acknowledging their role as holders of the deed of trust until the terms of the note are fulfilled. This note will not be acknowledged, and only one copy will be signed.

Deed of Trust

In a deed of trust (see Appendix C), the borrower (trustor) conveys property as collateral to a trustee that will hold title on behalf of the lender (the beneficiary) until the terms of the loan are satisfied. When the loan is paid in full, the trustee will reconvey the property to the trustor, as directed by the **release clause**. If the loan goes into default, the trustee will foreclose on the collateral to secure full legal title and will sell the property to recover the balance of monies due to the lender. Examine the uniform covenants itemized in the Note and Deed of Trust Purchase Agreement (found in Appendix D) to understand more fully the legal relationships between the parties to this loan agreement.

NOTE AND MORTGAGE

Another real estate financing instrument is the **note and mortgage**. The note is the promise to pay a debt, while the mortgage is the pledge of real estate as collateral to secure this promise. A mortgage instrument, although executed separately, invariably has a copy of the note attached to it or at least a reference to the note's conditions incorporated into the mortgage form. While a note by itself is legal evidence of a debt, a mortgage always needs a note in order to be a legally enforceable lien against the collateral.

The Note

A note is a contract complete in itself. Its terms specify the amount of money borrowed and under which conditions the debt will be repaid. After being signed by a borrower—without any additional signatures or acknowledgments—it becomes a legally enforceable and fully negotiable instrument of debt when in the possession of its bearer. If the terms of a note are met, the debt is discharged. If the terms of a note are broken, a lender may choose either to sue on the note or foreclose on the note's collateral if a mortgage has been arranged as security for the note.

A note does not need to be tied to a mortgage. When a note is used as a debt instrument without any related collateral, it is described as an unsecured note. Unsecured notes are often used by banks and other lenders to extend short-term personal loans. However, a real estate loan, described as a secured loan, always includes a mortgage with a note, often called a security.

A note generally includes the following provisions.

Date Signed. The date of a note's origination is clearly delineated in the form. Accurate dates are vital to every legally enforceable contract because time is always of the essence in identifying chronological order of priority rights.

Participants' Identities. The participants engaged in a loan contract are identified, and their relationship as borrower and lender is established. Some preprinted note forms identify the borrower as "the undersigned," and the lender's name is printed on the form.

Promise to Pay. The words *promise to pay* establish the precise legal obligation of the borrower. The fulfillment of the promise is the satisfaction of the obligation; a broken promise entitles the lender to seek legal remedies to recover any damages that might occur.

Payment Due Dates. The specific schedule of payments must be incorporated into the note. A systematic repayment program of principal and interest over the life of the loan is described as amortization. A plan can be designed for a number of time intervals, such as for monthly, quarterly, semiannual, or annual payments. Semi-amortized notes call for periodic payments of principal and interest, with a large principal amount, called a balloon payment, due at the end of the loan term. Notes can also be designed to be paid at a monthly or annual rate of interest only with a single lump-sum principal payment due at some future time. This form of finance is described as a term loan. In all cases, a note

will specify when the payments will start, on which dates they will be due, and when they will stop.

Amount and Terms. The amount of the payments depends on the terms of a loan. If a term loan for \$1,000 for one year at 6% interest per annum is designated, the note will stipulate a payment of \$1,060, including principal and interest, to be due in full one year from the date of its inception.

The payments due on an amortized note will be based on the length of time involved and the agreed-upon interest rate. For example, a \$150,000 note payable in monthly installments over a 30-year time span at 6% annual interest would require a \$599.56 regular monthly payment to satisfy the obligation. This sum represents only the monthly principal and interest amounts due the lender. If hazard insurance premiums and property taxes are to be included in the monthly payment, these additional requirements must be described in the mortgage form. Only the scheduled amount of principal and interest owed to the lender is specified in the note.

The terms and conditions for the repayment of a loan can be as flexible and varied as a particular situation demands. However, the note is always the determining instrument in interpreting the intentions of the parties to a loan.

Reference to Security. After the terms of a loan are specified, a referral is made in the note that it is secured by a mortgage upon real property. This reference to a security is formalized when a copy of the note is attached to its mortgage, thereby firmly and legally establishing the security.

The mortgage is the lien document, the life of which depends on the note. The note is a freestanding contract personally obligating the borrower for the debt. A lender may sue for damages on the note instrument in the event the borrower defaults. The mortgage is the lender's final protection and may be foreclosed if a borrower cannot fulfill the obligation under the note. Thus, the note is the power instrument in this realty lending design.

Signatures and Endorsements. Although several copies of the note are prepared and distributed to the parties in the loan transaction, only one copy is signed. This signed copy is delivered to the lender, to be held until the debt is satisfied. This is important to a borrower because each signed note is a negotiable instrument in itself. Only one note should be signed in any loan transaction.

A note requires only the borrower's signature. The delivery of the signed note to the lender is adequate evidence of ownership. A note signed by a borrower is a negotiable instrument; a lender can assign it to another person by simply endorsing it on its back, much like a check. If a mortgage is involved, the process is more complicated, but the note itself is a viable, negotiable instrument. A transfer does not affect either terms or conditions of the original agreement, except that the place to which the borrower sends payments may change. When the loan is repaid, the lender marks *paid in full* across the face of the original note, signs under this comment, and returns the original to the borrower.

Cosigners. The lender who once made the statement that "there can never be too many signatures on a note" was referring to the fact that all signers on a note are individually and collectively responsible for its repayment. If a married couple is securing a loan, a

lender will require both husband and wife to sign the note. Sometimes a lender may require the signatures of persons other than the borrower to provide additional guarantees that the obligation will be repaid. These additional signatures are usually the borrower's family or friends whose credit has been considered in qualifying the borrower for a loan. These cosigners share personal liability with the original maker of the note in the event of a default.

The number of signatures on a note does not have to conform with the number of persons who sign the accompanying mortgage. Because the property in question is being pledged as collateral to back up a specific note, only the property owners sign. Thus, a note may have more or fewer signatures than its mortgage. In fact, the signatures on both instruments may be different, although this would be rare. (A sample note is shown in Appendix C.)

The Mortgage

Mortgage provisions vary, depending on the policies of individual lenders and the circumstances in a particular transaction. The components covered in this section are standard to most mortgage forms (see Appendix E for a sample mortgage form).

Recording Information. A mortgage is a lien on a specific property or properties to secure the fulfillment of a promise—usually a promise to repay a debt. The only way a lender has to notify the world that there is a lien on a specific property is to record the mortgage at the office of the recorder in the county where the property is located.

Without the recording of the mortgage lien, only the borrower and the lender would know of the transaction. Other parties having an interest in the property would not receive notice of the lien. Thus, for its protection, a lender will insist on recording the mortgage. Generally, this recording will take place before the proceeds of a loan are distributed, although this technique varies from state to state. By holding back the disbursement of a loan until after recording, a lender or escrow agent has a last-minute opportunity to recheck the public records about the condition of the collateral property's title.

Most standard mortgage forms have a space at the top of the first page devoted to specific county recording information. Others leave a blank space elsewhere on the form to be filled in at the recorder's office. This lien vests at the date and time stamped on the mortgage document by the recorder's clock stamp.

Participants. The participants to a mortgage include a borrower, the **mortgagor**, and a lender, the **mortgagee**. In exchange for a certain consideration, usually a sum of money, a mortgagor will pledge property as collateral to back up the promise to repay a mortgage. The proper names of both mortgagor and mortgagee must appear on the mortgage form.

Pledge. Any rights owned by a mortgagor in real estate may be pledged as collateral for a loan. Most mortgages include the pledge of a property's fee simple ownership, although leasehold, mineral, water, and other rights less-than-a-freehold interest can be pledged.

The portion of the mortgage that pledges the mortgagor's rights is called the **granting clause**. It includes the words "grant, bargain, sell, and convey," which are the same words that appear on the face of a deed that transfers the ownership of a property from

a grantor to a grantee. These words of conveyance in the mortgage form actually transfer a quasi-legal, or equitable, form of ownership to the mortgagee, creating a lien that the mortgagee will either release when the loan is satisfied or perfect into a full legal fee if there is a default.

Property Description. All property pledged as collateral in a mortgage must be described accurately to prevent any future controversies. A description used in prior transactions is usually an adequate reference, and it can be copied onto the new forms. However, whenever a new subdivision is involved in a loan or some complication arises concerning a property description, it may be necessary to retain a surveyor to provide a precise legal description.

In addition to the real property described, most mortgage forms include the pledge of

“. . . all buildings and improvements now or hereafter placed thereon; all rents, issues, and profits thereof; all classes of property now, or at any time hereafter, attached to or used in any way in connection with the use, operation, or occupation of the above-described property; all property rights and privileges now or hereafter owned by a mortgagor . . . All of the foregoing shall be deemed to be, remain, and form part of the realty and be subject to the lien of this mortgage.”

Thus, the real property, anything that is permanently attached to it, and all of the mortgagor's rights in it are pledged as collateral for the loan.

Covenant of Seisin. The covenant of seisin is the clause stating that the mortgagors have title to the property described and that they have the authority to pledge the property as collateral. This covenant goes one step further by specifying that the mortgagors will warrant this title and guarantee that it is being pledged free and clear of any encumbrance not described in the mortgage document.

Although this clause is found in most standard mortgage forms, it is of little practical consequence because a mortgagor's warranty would be useless in the event of default. As a result, most mortgagees rely on a careful title examination and title insurance to protect against misrepresentation.

Note Attachment. It is not necessary to describe all terms and conditions of a note in the body of a mortgage. In fact, the parties to a loan often prefer not to reveal this information and merely indicate a reference to the note, using the phrase “this mortgage is given to secure the payment of a certain indebtedness evidenced by a note payable to the order of the mortgagee,” or words to that effect.

However, some forms provide a space for the attachment of a true copy of the note. Whatever the case, the borrower agrees in the mortgage to pay the full sum due according to the terms of the note.

Property Taxes. In addition to being obligated to repay a mortgagee according to the terms and conditions of the promissory note, a mortgagor must pay all property taxes, assessments, adverse claims, charges, and liens that may jeopardize the priority position of the mortgagee. Any negligence on the part of a mortgagor to pay these claims technically puts a mortgage into default.

Depending on specific circumstances, mortgagees may protect their interests by including as a condition of the loan contract that the mortgagor pay a proportionate share of the annual taxes with each monthly payment of principal and interest. These tax payments would then be held in a special impound or escrow account to accumulate over the year and be paid to the tax collector, usually the county treasurer, when they are due. This procedure has eliminated many of the problems connected with mortgagors who simply were not conditioned to putting aside the funds necessary for annual property taxes. In most commercial loans and some residential loans, however, the mortgagors still retain control over these tax payments, and they are not impounded by a mortgagee.

A mortgagee will closely supervise the prompt payment of all current property taxes because a tax lien takes a priority position over any other liens, recorded or not.

Insurance. Just as mortgagees must protect themselves by supervising the prompt payment of property taxes, they must also specify in their mortgage contracts that the homeowners insurance that includes both hazard and liability is to be provided and paid for by the mortgagor in an amount adequate to and under terms adequate to protect the mortgagee's interest in the property. In most cases, a copy of the insurance policy must be submitted to the lender a few days prior to closing. The insurance agency chosen by the mortgagor is subject to approval by the mortgagee. Due to the occurrence of numerous natural disasters in recent years, obtaining homeowners insurance has become more difficult. Lenders may require proof of insurance much earlier in the process.

Not only must adequate coverage be provided, the mortgagee must also be named as a coinsured party. The original policy must be deposited with the mortgagee, and proportionate shares of the insurance premiums must be included together with the monthly payment of principal, interest, and taxes. These hazard insurance payments are deposited in the impound account, together with the property taxes collected, and the funds accumulated are used to pay the insurance premiums when they become due. In this manner, a mortgagee supervises the current status of the insurance coverage of the collateral.

If a loss occurs, the check for the insurance proceeds is issued either to the mortgagee only or to the mortgagor and the mortgagee jointly, the latter having an opportunity to inspect the repairs prior to endorsing the check. In the former case, the mortgagee usually retains the right to apply the proceeds to the amount of the indebtedness or make the necessary repairs. Thus, a mortgagee can protect the value of the collateral during the entire life of the loan.

Maintenance of the Collateral. As a further protection of the mortgagee's interests, a mortgagor is required by the terms of a mortgage to preserve the value of the premises by maintaining its physical condition. A mortgagor is charged "not to permit or commit waste on said premises" and "to preserve and repair said property."

Defeasance Clause and Acceleration. A mortgage usually includes a **defeasance clause**. It "defeats" foreclosure by stating that the mortgagor will regain full, free, and clear title upon the repayment of the debt. It has also become standard procedure to

include an **acceleration clause** that outlines the consequences of failure to pay on the part of the mortgagor. The acceleration clause usually states the following:

“In the event of nonpayment of any sum of money, either principal, interest, assessments . . . adverse claims, encumbrances, charges or liens, premiums of insurance when due or failure to maintain said premises or to keep or perform any other agreement, stipulation, or condition herein contained, then the whole principal sum of said note, at the option of the mortgagee, shall be deemed to have become due, and the same, with interest thereon at the rate contracted, shall thereupon be collectible in a suit at law *or* by foreclosure of this mortgage, as if the whole of said principal sum were payable at the time of any such failure.”

This acceleration clause is at the heart of a mortgage in relation to a mortgagee's protection. Any of the neglects mentioned can result in a default of the contract's provisions and allow a mortgagee to accelerate the mortgage, granting the right to take the appropriate legal steps to recover the investment. A mortgagee can elect to sue on the note and pursue a mortgagor personally for any balance due or sue for foreclosure on the property pledged as collateral. In most jurisdictions, a mortgagee cannot pursue both actions at the same time. In most cases, the mortgagee forecloses against the collateral and files a subsequent suit against the mortgagor for any deficiency incurred from the sale of the collateral. In any event, in the absence of an acceleration clause, a mortgagee would have to sue on each payment as it became delinquent, not the entire debt. The full consequences of a default are examined in Chapter 10.

Signatures and Acknowledgment. Like the note, a mortgage must be signed by the mortgagors accepting the conditions of the contract. These signatures must also be dated and acknowledged by a notary public, attesting to their authenticity, because unacknowledged instruments are not accepted by a county recorder and are not admissible in a court as true evidence.

Release of Mortgage. When a mortgage loan is paid in full, it is removed from the records by recording a satisfaction of mortgage form, executed by the lender, indicating that the loan terms have been met.

CONTRACT FOR DEED (LAND CONTRACT)

Alternately known as a real estate contract, a land contract, a contract for sale, an agreement for deed, an installment sale, and articles of agreement, a **contract for deed** has as many forms as it has synonyms. A contract for deed does not have an accompanying note; it is a single, complete financing and sales agreement executed between a buyer and a seller. A contract for deed should not be considered a mortgage or deed of trust, even though the same basic conditions are incorporated into its form. These conditions include the pledge of specific property as collateral for the loan, the terms and conditions for the loan's repayment, the enumeration of the borrower's responsibilities, and a statement of the consequences of a default.

The contract for deed is an agreement drawn up between two parties, a buyer/borrower, the **vendee**, and a seller/lender, the **vendor**. Under a contract for deed, the seller remains the legal fee owner of the property, which is one major distinction between this form of financing instrument and the mortgage and deed of trust. Although the buyer agrees to pay the seller a specific price under certain terms and conditions, thereby gaining possession of the property, the buyer does not receive full legal title until the terms of the contract are met. This procedure provides the seller, who is financing the sale of the property, added protection in case of the buyer's default. Because every contract for deed is drawn up as a specific contract, no example is given here.

Components of a Contract for Deed

Because a contract for deed does not have a note accompanying it, all conditions of the sale are described in the contract form, including the purchase price and the terms of the loan. The contract specifies the buyer's responsibilities to pay the payments when due, as well as the taxes, special assessments (if any), and hazard insurance premiums. The contract also describes the deed that the seller will deliver to the buyer upon fulfillment of the contract or deposit with an escrow—if an escrow is used—to be held until the terms of the agreement have been met. The delivery and subsequent recording of this deed serve as proof of the satisfaction of the contract debt.

The contract directs the buyer to take possession of the subject property and maintain possession so long as the agreed-upon terms of the contract are met. In the event of a contract breach, all payments made by the buyer are forfeited. The seller may then elect to bring an action against the buyer for specific performance of the agreement or may choose to use any other legal remedies granted in the contract for recovery of the property and any losses incurred.

A contract for deed is both a sale and financing agreement in one instrument; both the buyer and seller sign the document and have their signatures notarized in anticipation of recording.

Foreclosure Power

The contract for deed goes one step further than the deed of trust. It places even more foreclosure power into the hands of the seller/lender in the event of a default. In fact, a lender under a contract for deed may be able to recover property pledged as collateral in as little as 30 days. When compared to the much longer property recovery periods of up to two years specified in the mortgage form—and up to four months under the deed of trust—the short term provided by a contract for deed gives the seller/lender significant additional security in case of default.

Some states, such as Colorado and Florida, require the seller/lender to foreclose a contract for deed as if it were a mortgage or deed of trust. Most frequently, the contract for deed form is used between individuals in the purchase and sale of real property when other means of financing are not readily available. Contracts for deeds are frequently junior financing instruments, established between a buyer and seller, to close a particular sale when the buyer does not have sufficient cash or credit to secure a new senior mortgage or trust deed loan.

Despite its seeming simplicity, the contract for deed form of financing real estate is relatively complicated. It must be recorded to protect the vendee's rights in the property. A collection escrow should be established to make sure the payments on the underlying loan or loans are made on time and that proper records are kept. Provisions must be made at the outset for delivery to the vendee of the deed when the contract is paid in full. This deed should be fully executed at the time of establishing the contract and deposited with the collection escrow. Because of these complexities (and others) in establishing a contract for deed, competent legal advice should be sought.

JUNIOR FINANCE INSTRUMENTS

When special problems or needs arise in the financing of real estate, junior financial instruments are often used as part of the solution. Generally, when a deed of trust, mortgage, or contract for deed is used as a second encumbrance, the loan involves a higher risk, and the lender should be aware of this circumstance.

Under normal conditions, most real estate sales are finalized when a buyer secures a new first deed of trust or mortgage from a financial institution to cover the major portion of a property's purchase price. The balance, if any, is usually paid in cash as a down payment. Frequently, however, a buyer who has insufficient cash for the entire amount of the required down payment will make an offer to purchase a property based on the condition that the seller carry back a portion of the sales price in the form of a purchase-money second mortgage or deed of trust (called a **carryback loan**).

Mortgage brokers, mortgage bankers, and various small loan companies operating on direct lines of credit from commercial banks also arrange junior loans. Some companies buy and sell these second securities on a regular basis. In addition to financing the purchase of commercial and residential properties, junior financing often provides funds for land developers to pay for off-site improvements such as streets, sidewalks, sewers, and other utility installations. A lender advances the funds necessary for these improvements and accepts a lien on all of the property involved. Such a lien usually is in second position behind a developer's purchase-money loan. Once the land is subdivided, improved, built on, and sold, the underlying first lien and the junior lien for improvements are replaced by individual conventional or guaranteed loans executed by the buyers of the buildings constructed on the developed land.

Second Mortgage or Deed of Trust

As its name implies, a **second mortgage** or deed of trust is a lien on real property that is second, or junior, in position behind an existing first lien. Just as the senior loan requires the execution of a note specifying the terms and conditions of the promise to pay, the junior loan calls for such a promissory note. In addition, the junior loan form itself is exactly the same as the senior loan form, except that the junior instrument includes—typed boldly on its face—the word *SECOND* to identify its junior priority position. The property that is described as collateral for the junior loan is the same property that is pledged as collateral for the existing senior loan.

Because the second loan is in a subordinate position, the junior lienholder is in a relatively high-risk position. If the senior encumbrance is not paid according to its terms and conditions, the senior lienholder may foreclose on the collateral property and sell it to recover as much of the outstanding senior debt as possible. This foreclosure process could effectively eliminate the junior lienholder's position in the subject property without commensurate compensation. After costs, the proceeds from the sale would be allocated to the senior lienholder first and then to the junior lienholder or lienholders, according to their priority positions. If the property did not sell for a price sufficient to satisfy the senior lender, no funds would be left to distribute to the junior lienholder(s).

In the event of a default, a senior lender knowing of the existence of a junior lien gives the junior lender a chance to step in and make the delinquent payments. The junior lender then forecloses against the collateral property, but the primary lender must be protected and will pursue any legal means available to maintain the value of the investment.

Clauses. Certain provisions can be incorporated into a junior lending instrument to protect the position of the junior lienholder against that of the senior lender. A clause can be included that grants the junior lender the right to pay property taxes, insurance premiums, and similar charges for a borrower who is not making these payments. These charges can then be added to the total debt in anticipation of foreclosure. Another clause can require the borrower to pay into escrow the funds for taxes, insurance, and the first mortgage payments to offset any possible delinquencies. The junior lender can also reserve the right to cure any default on the first mortgage.

Some junior mortgages include a **lifting clause** that allows a borrower to replace an existing first mortgage without disturbing the status of the junior mortgage. The amount of the new first mortgage cannot exceed the specific amount of the original first mortgage outstanding at the time the second mortgage was established. Finally, if a **cross-defaulting clause** is included in the junior mortgage provisions, a default on the first mortgage automatically triggers a default on the second mortgage.

Pledging Equity. Junior financing is often used by owners who have accumulated measurable equity in their property through a pay-down of the first mortgage principal balance, an inflationary rise in a property's value, or both. The property is pledged as collateral to secure funds over short-term periods. When these **equity loans** come due, borrowers frequently refinance to secure a new loan adequate to pay off all liens.

Owners may pledge their equity to secure funds for home improvements. Improvement loans are somewhat safer than other types of junior financing because they are secured not only by the equity pledged but also by the enhanced value of the improved property. Home equity loans face significant defaults when the economy slows. Particularly at risk are the high-yield loans amounting to more than 100% of the value of the collateral.

Third Mortgage. There are also third mortgages and deeds of trust, but these are relatively rare and used only occasionally. For example, a real estate broker may accept a third mortgage for the amount of a commission behind an already existing first mortgage and a purchase-money second mortgage carried back by the seller.

Junior Loan Interest Rates. Junior loans secured from mortgage brokers and bankers, fiduciary lenders, and small loan companies usually carry relatively high interest rates to offset to some degree the possibility of loss due to default. It is interesting to observe, however, that junior carryback loans issued by sellers intent on completing the sales of their property may actually provide a below-market interest rate.

As a practical matter, there can never be an effective legal limitation on the amount of interest that can be charged on a loan. If the law stipulates a specific interest rate that would constitute **usury**, a lender can circumvent the restriction by charging points or raising the principal amount to reach a desired effective yield. The imposition of usury limitations on real estate loans is currently obsolete.

SPECIAL PROVISIONS IN MORTGAGE LENDING INSTRUMENTS

All three instruments for real estate financing may be enhanced and expanded by a multitude of provisions designed to serve the specific requirements of individual loans. Some of the provisions to be reviewed in this chapter have already become standard practice and are incorporated regularly into loan instruments (e.g., prepayment privileges and/or penalties and due-on-sale clauses). Some special provisions are used only rarely and under unique circumstances, such as lock-in clauses, subordination, or release clauses.

Late Payment Penalty

Many real estate loans include a clause that imposes a penalty, called a late charge, on the borrower for any late payments. Although most lenders accept payments up to 10 days or 15 days after they are due without penalizing a borrower, later payments incur a penalty charge—usually 4 or 5% of the total payment or a flat fee of some previously specified amount. The penalty rate may vary by state.

Prepayment Privilege

A prepayment privilege, or a **prepayment clause**, usually allows a borrower to repay the balance of a loan at any time without any restriction or penalty. Some loans include a provision permitting certain portions of the balance to be paid in specific years. For instance, a note might include a prepayment privilege of no more than 10% of the original principal amount to be paid in any one year. Other loans might stipulate a fixed sum of money that can be paid in addition to the regular payments in a single year.

Prepayment Penalties

Normally, a lender does not want a borrower to prematurely repay a high-yield loan. If a borrower with a high-interest loan seeks to refinance the property, the existing mortgage would be repaid in full, and the lender will lose the opportunity for high earnings.

One way to control this is by including a prepayment penalty clause in the loan contract. This penalty usually constitutes a certain percentage of the original face amount of

the loan, a percentage of the outstanding balance of the loan, or some fractional penalty, such as three months' interest. For example, if a contract includes a prepayment penalty clause of 3% of the remaining loan amount, the owner of a property will be charged \$1,500 to repay an existing \$50,000 principal balance prior to its normal amortization.

A lender may wish to enforce the prepayment penalty when an existing loan is being replaced by a new loan at lower interest or by a loan secured from another lender. With the exception of jumbo ARMs, few loans today have a prepayment penalty. Some states have abolished the prepayment penalty entirely and FHA, VA, and most loans purchased by Fannie Mae and Freddie Mac do not permit any prepayment penalties.

Lock-in Clause

The most drastic form of prepayment control is a lock-in clause whereby a borrower is actually forbidden to pay a mortgage loan in full before a specific date, sometimes for as long as ten years after its inception. It seems obvious that this lock-in clause would be imposed primarily on very high-yield mortgage loans in order to preserve a lender's earning position for a prescribed time period.

Often combinations of the prepayment privilege, prepayment penalty, and lock-in clause are included in a single loan. For example, no prepayment would be allowed at all for a specified period of time from the date of the loan's inception. Then proportionate amounts of the loan would become payable in advance according to an agreed-upon schedule, with some penalty imposed if the loan were repaid after the three years but before its regularly scheduled time.

Due-on-Sale Clause

Many financing arrangements include a **due-on-sale clause**, also known as a call clause or right-to-sell clause. This condition stipulates that a borrower "shall not sell, transfer, encumber, assign, convey, or in any other manner dispose of the collateral property or any part thereof, or turn over the management or operation of any business on the collateral property to any other person, firm, or corporation, without the express prior written consent of the lender." The due-on-sale clause further stipulates that if any of the foregoing events should occur without the lender's consent, the loan balance becomes immediately due in full, with the threat of foreclosure if it is not paid.

In reviewing a new buyer's request for permission to assume a loan, lenders can insist on certain terms and conditions before approving such an assumption. Depending on the circumstances, a lender could require additional cash as a larger down payment, adjust the interest rate on the existing balance to reflect the current market rate more accurately, charge a fee for the assumption, or impose any or all of these conditions, as well as others.

These practices by lenders caused a great deal of consternation regarding the legality of the due-on-sale clause. Various state supreme courts upheld its validity, while others denied its enforceability. Some state courts ruled differently in cases involving federally chartered lenders versus state-chartered lenders.

On June 28, 1982, in the California case of *Fidelity Federal Savings and Loan Association v. de la Cuesta*, the U.S. Supreme Court settled those controversies and ruled in

favor of the ability of federally chartered banks and savings institutions to enforce the due-on-sale provisions. Assumption of conventional (non-government) loans has been rare since that time. The Garn-St. Germain Act of 1982 limited the enforcement of the due-on-sale clause in special situations, such as divorce settlements and the passing of title by inheritance.

Assumption Versus Subject To

In the absence of a due-on-sale clause, deeds of trust, mortgages, or contracts for deed are assumable by buyers of the collateral property. A buyer may arrange with a seller to purchase a property, assume an existing encumbrance, and make any arrangements for financing the difference between the balance of the existing loan and the purchase price. This difference can be paid for either in cash or by some form of junior financing or both.

There are two ways for a buyer to arrange responsibility for an existing loan. The loan can be **assumed** or the property purchased **subject to** any existing encumbrances. If a loan is assumed, the buyer, along with the original borrower and any intervening buyers who have also assumed the loan, becomes personally liable to the lender for its full repayment. In the event of a default, the lender will foreclose, sell the collateral, and sue the original maker of the note and mortgage, as well as all subsequent persons who assumed it, for any deficiencies incurred.

On the other hand, a buyer may purchase a property with an existing encumbrance but stipulate the purchase is subject to the lien of the debt. This approach eliminates the buyer's contingent personal liability in the event of a deficiency judgment. Only the original borrower and any subsequent assumers are liable. Under the subject to format, a buyer may simply walk away from the property, forfeit any equity that has accumulated, and avoid any future responsibility in the transaction.

Knowledge of the difference between the two approaches can be extremely useful under certain circumstances. For instance, a seller in a low-down-payment transaction would insist the buyer assume the underlying mortgage to bind more tightly the responsibility for the mortgage payments. Conversely, a buyer making a substantial down payment would insist on the subject to approach eliminating any contingent liability.

Whether the buyer assumes the loan or buys subject to the lien, the original maker of the note and mortgage remains primarily responsible to the lender until the loan is paid in full or a buyer goes through a process of full substitution.

Novation. **Novation** is a technique where the seller of a property can end personal legal liability as the originator of a real estate loan when the loan is being assumed. The original borrower, as seller, submits a request to the lender to be replaced with the new buyer as maker on the loan instrument. After the new buyer completes the qualifying process, including a credit analysis, and is accepted by the lender, the old borrower is completely released from liability. The transfer of obligation is completed by executing an amendment to the original loan contract. The new agreement is recorded to maintain the appropriate continuity of the property's title.

Although FHA and VA loans remain assumable with borrower qualification, most conventional loans are only assumable with lender permission and rarely occur today.

When interest rates are low, there is little incentive for a purchaser to attempt to assume an existing loan.

Subordination Clause

To subordinate means to place in a lower order, class, or rank. In real estate finance, **subordination** involves placing an existing encumbrance or right in a lower-priority position to a new loan secured by the same collateral property.

Any real estate finance instrument can be designed to provide for its subordination to the rights of some future lien. For example, a loan created to finance the sale of vacant land to a developer could include a subordination clause granting the developer an opportunity to secure new financing to construct houses on a portion of the already encumbered land. Because the construction lender for the houses would insist on being in first lien position, the existing loan given to buy the land would have to be subordinated on those specific portions to be financed with construction mortgages. The land mortgage would then be in a junior lien position to the first mortgagee on those specific parcels on which houses were to be built. The wording used to establish this type of subordination could be, “The mortgagee shall, upon written request from the mortgagor, subordinate the lien of this mortgage on the lot or lots specified in order of release, to the lien of a new construction loan or loans from a recognized lending institution.” Subordination is also employed with land leases where the interests of a landlord are subordinated to a new mortgage secured by a tenant in order to develop a parcel of land (see Chapter 7 – Leasehold Mortgage).

Release Clause

When two or more properties are pledged as collateral for a loan, some provision for releasing a portion of the collateral as certain amounts of the loan are repaid is usually incorporated into the financing instrument. An analysis of release clauses is included in Chapter 7.

Exculpatory Clause

When securing a new real estate loan, some borrowers require that their assets, other than the property being financed, be protected from attachment in the event of a future foreclosure. This limited personal liability can be established by the inclusion of an **exculpatory clause** in the loan contract. This clause stipulates that the borrower’s liability under the loan is limited to the property designated in the legal description. In the event of a default, the lender is limited to the recovery of the collateral property only and cannot pursue any deficiency judgments against the borrower’s remaining assets.

Nonrecourse Clause

Real estate loans are often sold in the financial market (see Chapter 4). When a **nonrecourse clause** is included in the sale’s agreement, the seller of the security is not liable if the borrower defaults. The buyer of the security must take action to recover the unpaid balance of the loan from the borrower or foreclose on the collateral. However, if a real

estate loan is sold with recourse, the seller of the security is obligated to reimburse the buyer if the borrower defaults.

Extensions and Modifications

Some loan instruments include provisions for extensions or modifications under special circumstances. Sometimes a lender will allow an extension of time for a financially troubled borrower to continue payments beyond a specific due date. Other lenders may make adjustments and modifications in loan contracts in order to meet particular problems arising after a loan has been in effect for some time. These modifications could include adjustments in payments, interest rates, due dates, or, in extreme cases, payment moratoriums.

In response to the financial crisis starting in 2007, the government provided several different loan modification programs in an effort to help at-risk homeowners avoid foreclosure. The most recent programs are Home Affordable Modification Program (HAMP) and Home Affordable Refinance Program (HARP). Under HAMP, the monthly mortgage payment may be reduced by as much as 40%. Refinancing under HARP lets the homeowner take advantage of current low interest rates.

Two major problems arise from an extension or modification of a real estate loan instrument. The first concerns the rights of an intervening lien or who may move into a priority position when an existing loan is recast. Lenders usually require a complete title examination prior to modifying their loans in order to meet such contingencies. The second problem is the possibility of negating the insurance or guarantee that a mortgage may have under its original form. In the event of any modifications to an insured loan, the guarantee may be lost.

Under some circumstances, such as a delinquent construction loan, the lender usually continues to carry the loan until the builder can sell the property to a qualified buyer. The delinquency is preferred to a modification and recasting of the loan, which might jeopardize mechanic's lien priorities.

SUMMARY

A person can borrow money by pledging interests in real estate as collateral to guarantee the promise to repay. Usually, a borrower's ownership interest in property is encumbered to a lender for this purpose. However, other property interests can also be pledged as collateral for a loan—interests such as leaseholds; life estates; and mineral, air, and water rights.

One instrument of real estate finance is the deed of trust, which pledges the subject property as collateral for a loan drawn in favor of a third-party trustee. A deed of trust includes a power of sale clause, and if a default occurs, the trustee can sell the property to recover any losses in as little as four months.

Another real estate financing instrument is the note and mortgage. A note is a promise to pay, while a mortgage is the pledge of a specific parcel of real property as collateral to secure this promise. A note signed by a mortgagor is a negotiable instrument that specifies the terms and conditions for the repayment of a debt. A mortgage signed by both

mortgagor and mortgagee establishes a lien on the collateral property as of the date it is recorded. When a mortgage debt is paid in full, the mortgagee marks the note *paid in full*, signs it, and returns it to its maker, along with a satisfaction of mortgage form, which will clear the record of the mortgage lien.

A contract for deed is, at the same time, both a sales agreement and a financing instrument between the buyer/borrower/vendee and the seller/lender/vendor. The full terms of the sale, as well as the manner in which the loan will be repaid, are elaborated in this contract financing form. The buyer is granted possession and control of the property during the term of the payments under the conditions specified in the contract. When the terms of the contract are satisfied, the seller delivers a deed to the buyer, which transfers full legal title. The contract for deed form of real estate financing is used primarily when other financing means are not available.

When a prospective property buyer does not have enough cash to satisfy the down payment requirement, a second mortgage, second deed of trust, or junior contract for deed may be carried back by the seller to finance the difference. Owners often pledge their equity as collateral for home improvement loans or personal needs. Junior instruments of finance are second in priority to an existing senior loan.

All three financing instruments may be expanded by a variety of provisions designed to serve the needs of individual borrowers and lenders. Real estate loans may include special provisions to allow for the prepayment of portions of the principal from time to time. Other loans impose prepayment penalties if the loan is paid prior to its regularly scheduled completion date. A lock-in clause prohibits any prepayment for certain specified time periods. Penalties imposed to inhibit prepayments are usually designed to preserve a lender's earnings position, and these penalties are generally included in high-interest rate loans.

Although some federally insured or guaranteed mortgages are assumable without the consent of their lenders, most conventional mortgages include a due-on-sale clause, which stipulates that a borrower cannot sell the collateral property or transfer it in any manner without the prior written consent of the lender. In the absence of a due-on-sale clause, property may be sold with the existing loan remaining in effect. The buyer has two ways in which to arrange responsibility for an existing loan. It can be "assumed," in which case the buyer along with the original borrower becomes personally liable for the loan. The buyer can also make the purchase "subject to" this encumbrance. The latter technique eliminates the buyer's personal liability on the loan, although the originator of the loan remains personally liable until the loan is paid in full. Infrequently, a seller requires a buyer to pursue a process of novation, which, upon its successful completion, substitutes the buyer for the seller on an existing loan contract.

To subordinate a finance instrument is to change its priority lien position in relation to subsequent loan instruments. Lending instruments may also be extended or modified to solve unforeseen financial problems. With the written agreement of all parties to a loan contract, a payment can be altered or waived for a certain time period.

INTERNET RESOURCES

Examples of various contract forms can be seen at the following websites:

www.uslegalforms.com

www.findforms.com

www.lawdepot.com

Some state or local associations of REALTORS® may also have sample forms available.

REVIEW QUESTIONS

1. Which circumstance would create a voluntary lien?
 - a. Mortgage on the property
 - b. Overdue property taxes
 - c. Unpaid contractor who installed a swimming pool
 - d. Judgment from an unpaid hospital bill
2. *First in time, first in right* generally gives the first mortgage lender a priority lien position, the only exception being
 - a. a mechanic's lien.
 - b. a judgment lien.
 - c. a second mortgage lender.
 - d. an unpaid property tax.
3. A lender may prefer to have a deed of trust instead of a mortgage because
 - a. foreclosure is accomplished more easily and quickly.
 - b. a deed of trust takes less paperwork.
 - c. a deed of trust has no redemption period.
 - d. a deed of trust does not require foreclosure.
4. Which statement regarding a note is *FALSE*?
 - a. A note is a promise to pay a debt.
 - b. A note is a complete contract.
 - c. A note must be tied to either a mortgage or deed of trust.
 - d. A note is a fully negotiable instrument.
5. When the mortgage loan is fully paid, the borrower (mortgagor) regains full and clear title to the property based on which clause in the mortgage?
 - a. Acceleration clause
 - b. Power-of-sale clause
 - c. Defeasance clause
 - d. Exculpatory clause
6. A homeowner sells his property to an individual, retaining title to the property until the loan has been paid in full. The homeowner has executed a
 - a. purchase contract with note and deed of trust.
 - b. purchase contract with note and mortgage.
 - c. contract for deed.
 - d. purchase contract with note only.
7. A seller was willing to allow a purchaser to assume his current conventional loan, but the lender would not allow it. The lender was exercising his rights under the
 - a. due-on-sale clause.
 - b. release clause.
 - c. prepayment penalty clause.
 - d. acceleration clause.
8. A buyer was able to purchase her new home, taking over the payments from the current owner. Although the buyer is responsible for making the payments, in the event she should default on the loan, the lender will look to the original borrower for payment of the balance due. The home was bought
 - a. on a land contract.
 - b. subject to the debt lien.
 - c. by assuming the first mortgage.
 - d. with an FHA assumption.
9. Although a developer now has a loan with his local bank for the eight properties he is building, he must be able to give clear title to each property as they are sold. In order not to be required to pay off the entire loan before conveying each individual property, the mortgage *MUST* include
 - a. an acceleration clause.
 - b. a subordination clause.
 - c. a release clause.
 - d. an exculpatory clause.

10. Lenders may be willing to waive payments temporarily but are usually reluctant to modify, or recast, the original loan agreement due to their concern that
 - a. the borrower may no longer be qualified.
 - b. an intervening lienholder may move into the priority position.
 - c. it takes too much paperwork.
 - d. they would rather foreclose on the property.

Real Estate Financing Programs

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- provide an example of both a 30-year and a 15-year loan for a specific amount, comparing the difference in payment and in interest paid over the life of the loan;
- list the basic guidelines for conventional conforming loans;
- describe the components of an adjustable-rate mortgage;
- explain the concept of private mortgage insurance and how it protects the lender; and
- differentiate between subprime and predatory lending.

adjustable-rate mortgage (ARM)

ad valorem

amortization

balloon payment

blanket mortgage

boot

buydown

completion bond

draws

escrow funds

fixed-rate loan

hazard insurance

homeowners insurance

Home Equity Line of Credit (HELOC)

impound funds

interest-only loans

interest rate factor

Internal Revenue Code Section 1031

lease option

lease purchase

loan-to-value (LTV) ratio

manufactured housing

negative amortization

package mortgage

piggy-back loan

point

private mortgage insurance (PMI)

predatory lending

reverse annuity mortgage (RAM)

right of first refusal

split loan

stop date

Streamlined Modification Program (SMP)

subprime lenders

Real estate loans can be as flexible and adaptable as needed to satisfy market demands. Contemporary financing techniques offer an opportunity to provide for most contingencies by varying one or more of the four basic characteristics of a real estate loan—the principal amount, the interest rate, the payment schedule, and the repayment terms. Each loan lends itself to a number of variations, limited only by the imaginations of those involved. This chapter begins with a discussion of interest and how it applies to mortgage lending then continues with an explanation of many different types of lending programs.

INTEREST

From a borrower's point of view, interest can be described as rent paid for the use of money. A lender views interest as money received or earned from a loan investment. Just as rent is paid and received for the use of an apartment, house, office, or store under the special conditions of a lease, real estate finance can be considered the process by which interest and principal are paid and received under the terms and conditions of a loan agreement. Money is borrowed (leased) at a certain interest rate (rent) for a specified time period during which the amount borrowed is repaid.

The amount of rent that a landlord can charge for the use of property depends on the rental market for that particular type of real estate. Similarly, the rate of interest that a lender can charge depends on the money market as it affects that particular type of loan. A rational borrower will not pay a lender more interest than the lowest interest rate available on a specific loan at a particular time.

Simple Interest

Most loans made on real estate are established at a simple rate of interest. Simple interest is rent that is paid only for the amount of principal still owed. When money is repaid to the lender, rent for that money stops.

The formula for computing simple interest is the following:

$$I = PRT$$

where

I = Interest

P = Principal

R = Rate

T = Time

■ **FOR EXAMPLE** Using this formula, the interest on a \$1,000 loan to be repaid in one year at 8% is \$80.

$$I = PRT$$

$$I = \$1,000 \times 0.08 \times 1$$

$$I = \$80$$

Interest Rate Factor

The **interest rate factor** represents the dollars required to pay off \$1,000 of a loan for a set number of years on a fully amortized loan that will be paid off at the end of the loan term. Figure 7.1 illustrates how the factor changes according to the rate of interest and the term of the loan. Note that the interest rate and the factor are the same only at a rate of 6% for a 30-year loan.

Interest-Only Loans

Term Loan. Also known as a straight loan or bullet loan, a term loan requires payments of interest only with the entire principal being repaid at a specified time, called the **stop date**. The loan is then paid in full with a **balloon payment** of the principal plus any interest still owed.

■ **FOR EXAMPLE:** Consider a term loan of \$10,000 at 8% per annum, payable interest only monthly, to be paid in full in three years.

Loan Amount	\$10,000
Interest Rate	× 0.08
Annual Interest	800
Pro Rata Months	÷ 12
Monthly Interest Payment	= 66.66
Final Principal Payment	+10,000
Balloon Payment	\$10,066.66

FIGURE 7.1 Monthly Payment Required to Amortize a \$1,000 Loan

Years	5%	5.5%	6%	6.5%	7%	7.5%	8%
5	18.88	19.11	19.34	19.57	19.81	20.04	20.28
10	10.61	10.86	11.11	11.36	11.62	11.88	12.14
15	7.91	8.18	8.44	8.72	8.99	9.28	9.56
25	5.85	6.15	6.45	6.76	7.07	7.39	7.72
30	5.37	5.68	6.00	6.33	6.66	7.00	7.34

To compute the monthly principal and interest, multiply the number of thousands in the loan by the appropriate factor. For example; \$150,000 30-year loan at 7% interest: $150 \times 6.66 = \$999$ per month

When residential real estate prices reach new highs, qualifying borrowers for higher mortgage payments on larger loans becomes a serious problem. In order to reduce monthly payments, the use of **interest-only loans** emerges as an alternative type of loan.

When you examine the fixed-rate loan payment schedule in Figure 7.1, the regular monthly payment of \$999.00 includes an amount for principal and interest and is designed to pay the debt of \$150,000 at 7% in full over the 30-year time period.

To reduce this payment, the only portion that can logically be waived is the principal amount, reducing the payment to interest only. To reduce this payment any further would be paying less than interest only, which would result in the loan balance increasing each month by the difference, resulting in **negative amortization**.

There are several alternatives for interest-only loans. One option is to establish a five-year stop date with a balloon payment as described previously. These monies can be received from refinancing the property, which, hopefully, will have retained or increased its value over time. Another plan would be to establish a series of smaller balloon payments over time to gradually whittle the balance down to zero. A variation of the interest-only loan is a loan with interest-only payments for 15 years, with the remaining payments adjusted to cover the total interest and principal needed to repay the loan over the remaining term. Borrowers have the option to prepay the principal at any time.

Before the financial crisis of 2008, the interest-only loan was employed as a financing device on loans that equaled or exceeded the full purchase price of the collateral property, creating risky portfolios. As long as the housing market enjoyed an inflationary movement, these lenders were protected. However, the significant downturn in the market resulted in many loan defaults and foreclosures.

Points

A **point** is 1% of the total loan amount. For example, one point of a \$200,000 loan is \$2,000. Lenders charge discount points as up-front interest to lower the interest rate for the borrower while raising the yield for the lender. The number of points charged varies according to market conditions. A loan may be quoted as “5.5% with 3 points.” One of the points is usually for the origination fee, which pays for the lender’s processing expenses.

Permanent/Temporary Buydown Plan

A **buydown** is money paid by someone (e.g., seller, builder, employer, buyer) to a lender in return for a lower interest rate and monthly payment. The buydown payment is essentially interest paid in advance and may lower the borrower’s payments for the entire loan term (a permanent buydown) or for a lesser period of time, usually one to three years (a temporary buydown). Each percentage of buydown is quoted as a point. Buydowns are often used as a selling tool for new home builders.

■ **FOR EXAMPLE** Assume a \$100,000 loan for 30 years at 8%. To apply a temporary buydown of 2-1-0 would cost \$2,432.04 or approximately two and one-half points.

<i>Payment</i>	<i>Rate</i>	<i>Reg. P&I</i>	<i>Effective Rate</i>	<i>P&I</i>	<i>Difference</i>
1st year	8%	\$733.77	6%	\$599.56	\$134.21
2nd year	8%	733.77	7%	665.31	68.46
3rd year	8%	733.77	8%	733.77	0.00
Etc.					

Buydown Cost 1st Year	$\$134.21 \times 12 = \$1,610.52$
Buydown Cost 2nd Year	$\$68.46 \times 12 = \underline{\$821.52}$
Total Buydown Costs	\$2,432.04

In most cases, it is not economically feasible for a borrower to pay for a buydown. Before making this decision, the buyer should calculate how long it would take to recover the additional cost at settlement.

Amortization

The most common payment format for a real estate loan is a system of regular payments made over a specified period. These payments include portions for both principal and interest. The process is called **amortization**. Amortization tables are available in text form and online.

■ **FOR EXAMPLE** Consider a loan of \$90,000 at 7% for 30 years. The monthly payment of principal and interest is \$599.40. The rate factor is 6.66.

Number of Thousands	90
Payment Factor (Figure 7.1)	$\times 6.66$
Monthly Payment P&I	\$599.40

Note: There will be a slight difference between a payment calculated by calculator and one calculated from a factor table due to rounding.

Distribution of Principal and Interest. Intrinsic in the amortization design is the distribution of the level payments into proportionate amounts of principal and interest.

■ **FOR EXAMPLE** Consider the \$90,000 loan at 7% interest for 30 years with a monthly principal and interest payment of \$599.40.

<i>Payment No.</i>	<i>Balance</i>	<i>Interest</i>	<i>Principal</i>
1	\$90,000.00	\$525.00	\$74.40
2	89,925.60	524.57	74.83
3	89,850.77	524.13	75.27
4	89,775.50	523.69	75.71
Etc. to 360			

The schedule in the previous example can be extended for the full period of 360 months to show the complete distribution of principal and interest and the remaining balance of the loan at any time. These amortization schedules can be prepared on computer printouts and are often presented by lenders to borrowers so they can follow the progress of their payments. Amortizing schedules are also available to the public online.

Interest Adjustment. Mortgage payments are normally paid in arrears. For example, a payment made on May 1 covers the principal due on that day plus the interest charged for the month of April. At closing, interest is usually charged to the borrower to cover the period from the closing date to the end of that month. The next full payment will not be due until the following month. For example, the closing is on June 15, interest is charged from June 15 to June 30, and the next payment is due on July 1.

TYPES OF LOANS

There are two general categories of real estate loans: conventional and government. Conventional loans can be conforming (conforming to guidelines set by Fannie Mae and Freddie Mac) or non-conforming (those that do not meet the Fannie/Freddie guidelines). Government loans are those insured by the Federal Housing Administration (FHA), guaranteed by the Veterans Administration (VA), provided by the U.S. Department of Agriculture (USDA), or provided by special programs created by individual states or local jurisdictions. Most originators of conventional loans do not keep them for their own portfolios but sell them in the secondary market. They frequently keep the collection responsibilities and the commensurate fees for servicing the loans. Packages of loans are sold on the secondary market to Fannie Mae, Freddie Mac, the Federal Home Loan Bank, and private investors.

The majority of real estate loans originated over the past two decades were conventional loans; however, as a result of the financial crisis in the mortgage lending industry that began in 2007, a large number of borrowers have turned to FHA financing. Both conventional and government loans are available in different variations. The most common ones are described here.

Fixed-Rate Loans

The most traditional loan product is the **fixed-rate loan**, in which the interest rate remains constant over the term of the loan. Fixed-rate loans may be amortized over a specific number of years in equal monthly payments, including principal and interest. The most popular fixed-rate loan is the 30-year mortgage, where the principal and interest portion of the payment remains the same with only slight annual changes in the portion set aside for escrow funds to pay property taxes and homeowner insurance. Even though the amount paid towards principal is very small at first, the result of this payment format is that the borrower begins to build equity with the first monthly payment. In most cases, the borrower is allowed to pay off the loan early if so desired.

■ **FOR EXAMPLE** Consider a 30-year, fixed-rate, self-amortizing loan for \$100,000 at 7%.

<i>Month</i>	<i>Fixed Payment</i>	<i>Interest</i>	<i>Principal</i>	<i>Balance</i>
0				\$100,000.00
1	\$665.31	\$583.33	\$81.98	99,918.02
2	665.31	582.85	82.46	99,835.56
3	665.31	582.37	82.94	99,752.62
4	665.31	581.89	83.42	99,669.20
5	665.31	581.40	83.91	99,585.29
Etc., to 360				

Fixed-rate loans for 15 years are also popular with borrowers who wish to have their home paid for within a 15-year period. Lenders like them because of their relatively short amortization time, and they market these loans on the basis of the borrower being able to save significant amounts of interest, compared with the 30-year loan. A 15-year loan is usually offered at 25 to 50 basis points below market rates (there are 100 basis points in 1%, so 25 basis points equal one-fourth of 1%, and 50 basis points equal one-half of 1%). However, the monthly payment required on the 15-year loan is approximately 20% higher than the payment on the 30-year loan, which limits the number of borrowers who can afford the higher payment.

■ **FOR EXAMPLE** Consider a 15-year, fixed-rate, self-amortizing loan for \$100,000 at 7%.

<i>Month</i>	<i>Fixed Payment</i>	<i>Interest</i>	<i>Principal</i>	<i>Balance</i>
0				\$100,000.00
1	\$898.83	\$583.33	\$315.50	99,684.50
2	898.83	581.49	317.34	99,367.16
3	898.83	579.41	319.42	99,047.74
4	898.83	577.77	321.06	98,726.68
5	898.83	575.90	322.93	98,403.75
Etc., to 180				

Impound or Escrow Funds

In addition to the principal and interest, the lender often collects monthly amounts needed to pay annual taxes and insurance. These amounts, called **impound funds** or **escrow funds** in different parts of the country, are determined by dividing the total amounts due each year by 12. Although the principal plus interest payment remains constant over the life of the loan, the amount needed to pay the taxes and insurance may vary, resulting in a change in the total monthly payment. At the end of the year, some adjustment may need to be made if the escrow fund is either over or under the allowed amount.

On rare occasions, a property owner may be charged an assessment lien for off-site improvements such as a sewer or street paving. Because these improvement district bonds are a priority lien, the lender may insist that a proportionate monthly amount be escrowed (impounded) along with the taxes and insurance.

Property Taxes

Property taxes are charged to property owners as a basic source of funds to pay for public services of state, county, city school district, and other local governmental jurisdictions. Because liens for non-payment of property taxes take priority over other liens, lenders require the escrowing of funds to ensure that funds are available when needed.

The taxing process begins by determining the funds needed to satisfy the specific budgetary requirements of each governing body within the taxing district for the following fiscal year. At the same time, every county assessor must maintain a current inventory of the fair market value of all privately owned real property within the county's boundaries. Thus, the term coined for this form of taxation is **ad valorem** (i.e., according to value). Most counties apply an assessor's factor to the fair market value, which reduces this amount to an assessed valuation of all taxable property within the county.

The tax rate to be applied to individual properties is derived by dividing the total budgetary requirements of the taxing district by the total value of the taxable property within the jurisdiction. The tax rate is usually expressed in terms of so many mills (thousandths of a cent) or dollars per thousand dollars of assessed value.

■ **FOR EXAMPLE** A taxable property having a fair market value of \$200,000 in a jurisdiction that applies a 35% assessor's factor would have a \$70,000 assessed valuation. If the tax rate on this particular property is \$50 per \$1,000 of assessed value, also described as a \$50-mill rate, the tax to be paid for the year is \$3,500. This owner would pay \$291.67 monthly for the property tax impound ($\$3,500 \div 12 = \291.67).

Hazard/Homeowners Insurance

In addition to the property tax impound, a lender usually requires that a proportionate share of the homeowner insurance premium be included in the monthly payment. **Hazard insurance** premiums are based on risk—the higher the risk, the higher the insurance premium. The insurance rate for a wood-frame house located in a rural area far from any possible fire-fighting service would be higher than the rate for a brick home situated two blocks from a fire station. Also, if an area is vulnerable to hurricanes, tornadoes, excessive floods, or other natural disasters, insurance rates will reflect these risks.

Homeowners insurance includes both hazard and liability and is generally preferred by the lender. It also provides the best protection for the homeowner. Whatever method is used to determine the insurance rate, one-twelfth of the annual premium will be included in the monthly payment. A homeowners insurance policy with a \$360 annual premium will require an additional \$30 per month be included in the payment.

Variable Payment Mortgages

Traditionally, most loans are fairly standard in their payment schedules, requiring a certain sum to be paid at regular intervals over a prescribed time period. However, some real estate loans are designed to vary the required payments and interest to reflect more accurately the financial capabilities of a borrower, as well as the current state of the economy.

These alternative mortgage instruments allow a lender's return to keep pace with prevailing interest rates while simultaneously providing a borrower the opportunity to qualify for larger mortgage amounts.

Adjustable-Rate Mortgage (ARM)

The interest rate of an **adjustable-rate mortgage (ARM)** is adjusted in accordance with a prearranged index. The ARM usually includes an annual interest rate cap to protect the borrower from volatile interest rate fluctuations. In addition, there usually is an overall interest rate cap over the entire term of the loan. A large part of the blame for the financial crisis starting in 2007 was laid on the consequences of borrowers with ARMs where the payments escalated beyond the borrower's ability to pay. Reasonable annual and life-of-loan caps may have prevented some of those losses.

Components of an ARM that should be considered when selecting an adjustable-rate mortgage include the following.

Adjustment Periods. This indicates the frequency of interest rate adjustments with concomitant payments. For example, the interest on a one-year ARM can change every year, while the interest on a three-year ARM can only change every three years.

Initial Rate. Sometimes called the teaser rate, it will always be below the market rate in order to attract borrowers to this type of loan.

Note Rate. The note rate or the calculated rate is the adjusted rate (index plus margin), imposed from time to time at the adjustment period.

Qualifying Rate. Because ARM interest rates fluctuate from time to time, the rate at which to qualify a borrower often creates problems. If the initial loan rate is low but is expected to increase in the near future, the borrower may not be able to make the higher payments. Lenders may require a borrower making less than 20% down payment to qualify at the maximum second-year rate. However, all interest rate adjustments on the loan will be made from the initial loan rate.

Index. The index is the starting point to adjust a borrower's applicable interest rate. Lenders must use an index that is readily available to the borrower but beyond the control of the lender. Some indexes are more volatile than others. Those most frequently used are the

- one-year constant-maturity Treasury (CMT) securities,
- Eleventh District Cost of Funds Index (COFI), and
- London Interbank (LIBOR) interest rates.

Margin. Each lender adds a margin percentage rate to the index at every adjustment period to derive the new note rate. Individual lenders set their own margins based on their estimated expenses and profit goals. The margin percentage rate may not change throughout the life of the loan. Typical margins range from 2 to 3%.

Interest Rate Caps. Most variable rate loans include an annual cap applied to the adjusted interest rate. This cap limits interest rate increases or decreases over a stated period of time and varies from lender to lender and ranges from one to two percentage points per year. Most lenders also include a life-of-the-loan interest cap ranging up to 6%. This combination of caps should provide the borrower protection against debilitating payment increases.

Payment Caps. Some lenders use annual payment caps instead of interest rate caps. The most common payment cap is 7.5% of the initial payment. This is equivalent to a 1% change in the interest rate. This means a payment of \$750 per month, principal and interest, could not vary up or down more than \$56.25 per month in one year's time. These payment caps are also combined with life-of-the-loan caps in some plans.

Most variable-rate loans do not include a prepayment penalty. Without this penalty, a borrower can more easily refinance to a fixed-rate mortgage. Some lenders also include a convertible loan feature that allows a variable-rate loan to be changed to a fixed-rate loan after the initial adjustment periods have been completed. A sample fixed-/adjustable-rate note appears in Appendix F.

All ARM originations from federally insured lending institutions must comply with disclosure regulations. Under an amendment to Regulation Z, the borrower must receive

- a descriptive ARM brochure;
- details of the specific loan program; and
- an illustrative example, based on a \$10,000 loan, showing how the payments and loan balance have been affected by historical changes in the index.

Graduated-Payment Mortgage (GPM)

A graduated-payment mortgage is designed with lower payments in the early years of a loan. These payments increase gradually until they are sufficient to amortize the loan fully. A GPM may specify less-than-interest-only early payments. This results in negative amortization, and the principal amount owed increases over time by the amount of the deficiency. This type of loan is rarely seen today.

Low Documentation Loans

Some major lenders have offered a program for those with good credit and steady income who wished to avoid the hassle of providing documentation to be approved. Sometimes called a low-doc loan, this program was especially appealing to self-employed and commission-income borrowers. In most cases, a high credit score was required, and the interest rate may have been slightly higher. As mortgage qualifying standards have become tighter since 2008, low-doc loans are rarely available.

Home Equity and Home Equity Line of Credit (HELOC)

When the Tax Reform Act of 1986 eliminated the tax deduction for interest paid on everything except home mortgages, the home equity loan became an important financing tool for many Americans. In most cases, the interest paid is tax deductible, and the funds may be used for any purpose. A home equity loan is usually made at a lower rate of interest than credit card or other short-term financing and can be either a fixed-rate or adjustable-rate loan. The amount that can be received is based on a percentage of the equity in the home and is limited to a combined loan-to-value (CLTV) ratio of the first mortgage plus the equity loan (most commonly 90 or 95%). In almost all cases, the home equity loan establishes a second mortgage as collateral for the loan, and closing costs can be rolled into the loan. An obvious disadvantage of the home equity loan is that the borrower is using up the equity established in the home in the present and will reduce the amount to be received upon an eventual sale of the property. As a result of the recent financial crisis, the percentage of the CLTV is likely to be lower with most banks.

A popular version of the home equity loan is the **home equity line of credit (HELOC)**. The line of credit is set up in the same way as the home equity loan, but rather than the borrower receiving the maximum amount as a lump-sum payment at closing, the borrower can write an access check, make a withdrawal with a VISA access card, or transfer funds online for any amount up to the approved limit whenever funds are needed for almost any purpose. Each lender establishes its own criteria, but, generally, the draw period ranges from 10 to 20 years and has been up to 90 or 95% of combined LTV, although the percentage is likely to be lower today. As house prices have declined, some banks have even lowered the amount available on an existing HELOC. Closing costs may be charged, and an appraisal of the property is usually required. No interest is paid until funds are withdrawn; however, many HELOCs have adjustable-rate interest and could become expensive if rates escalate.

Home Ownership and Equity Protection Act of 1994

The Home Ownership and Equity Protection Act of 1994 (HOEPA) addresses certain deceptive and unfair practices in home equity lending. The law was strengthened by the Federal Reserve with an amendment to the Truth in Lending Act (TILA) in Section 32 of Regulation Z. Under this amendment, home loans are covered if the annual percentage rate exceeds the rate of Treasury securities of comparable maturity by more than eight percentage points (10% for second mortgages) or the fees and points paid by the borrower exceed \$592 (2011 figure), including the cost of credit insurance and other debt protection products paid at closing. The amount is adjusted annually by the Federal Reserve Board, based on the Consumer Price Index. For more information on the types of loans covered, required disclosures, and prohibited practices, go to www.ftc.gov/bcp/edu/pubs/consumer/homes/rea19.pdf.

Reverse Annuity Mortgage (RAM)

This plan is based on a borrower's ability to capitalize on accumulated equity and is designed to enhance the income of the elderly. Many senior citizens own their homes free and clear but face the problem that their incomes are fixed and relatively low. Thus,

the **reverse annuity mortgage (RAM)** allows them to use their equities, with the lender paying the borrower a fixed annuity.

The property is pledged as collateral to a lender, who may provide funds to the borrower in one of the following three ways:

- Funds may be provided with regular monthly checks to the borrower until a stipulated balance has been achieved with no cash payment of interest required. The increase in the loan balance each month represents the cash advanced, plus interest on the outstanding balance.
- An initial lump-sum payment may be provided.
- A line-of-credit on which checks may be drawn may be provided. When the maximum loan amount is reached, the borrower is obligated to start repayment. In some cases, this requires the sale of the property.

■ **FOR EXAMPLE** An eligible couple (at least 62 years old) owns a \$37,500 house free and clear, but they need additional money to supplement their retirement income. With a RAM, a lender could make monthly payments of \$147 to the couple for ten years. At the end of the term, the couple would have received a total of \$17,607 and would owe \$30,000 plus all interest and fees involved. If the couple lived beyond the ten-year period, they could sell their home and move to other living quarters. Most participants in RAMs anticipate the need for a change in housing by the time the repayment requirements mature.

Under the HUD reverse mortgage program, known as the Home Equity Conversion Mortgage (HECM), the monthly payments continue for as long as the borrowers live in the home, with no repayment required until the property is sold (see Chapter 8 for more information on the HECM program).

Conventional Conforming Loan Products

A conventional conforming loan is one that follows the Fannie Mae/Freddie Mac qualifying guidelines. Loans that do not meet the criteria set up by Fannie Mae and Freddie Mac are considered to be nonconforming loans and will not be purchased by Fannie Mae or Freddie Mac on the secondary market. The following four basic Fannie Mae and Freddie Mac guidelines are generally used to qualify borrowers for conventional loans. The actual percentage ratios shown for both housing (Rule 1) and debt (Rule 2) are not as significant today because most underwriting is done by computer.

- Rule 1. Principal, interest, taxes, property insurance, private mortgage insurance, and any applicable condominium or homeowner association fees shall not exceed 28% of borrower's gross monthly income.
- Rule 2. All of the previously listed plus monthly debts shall not exceed 36% of borrower's gross monthly income.
- Rule 3. Borrower must have good credit.
- Rule 4. Borrower must have stable employment.

It is important to know that loan underwriters have flexibility in applying these guidelines in specific cases and that the rules can be changed from time to time. For example, special affordable loan products such as Fannie Mae's MyCommunityMortgage® and Freddie Mac's Home Possible® mortgages often have higher qualifying ratios. The worksheet shown in Figure 7.2 is based on basic standard ratios of 28% of gross monthly income (GMI) for total housing expense and 36% of GMI for total debt to income.

FIGURE 7.2 Conventional Loan Borrower Qualification Worksheet

Mortgage	\$ _____	
Gross Monthly Income	\$ _____	(A)
Housing Expense		
Principal and Interest	\$ _____	
Property Taxes	_____	
Homeowners Insurance	_____	
Monthly PMI Premiums	_____	
Association Fees	_____	
Total	\$ _____	(B)
Debts		
Installment Obligations	\$ _____	
Revolving Charges (Minimum Payment)	_____	
Auto Loans	_____	
Child Support/Alimony Payable	_____	
Child Care Expenses	_____	
Other	_____	
Total Debts	\$ _____	(C)
$(B \div A) \times 100 =$ _____ %	Housing expense (B) should be less than 28% of gross monthly income (A)	
$[(B + C) \div A] \times 100 =$ _____ %	Housing expense (B) plus long-term debt (C) should be less than 36% of gross monthly income (A)	

■ **FOR EXAMPLE** The borrowers have a combined gross monthly income of \$5,000. The loan amount applied for is \$100,000 at 7.5% for 30 years payable at \$699.22 per month principal and interest. The monthly property taxes are \$300, insurance is \$30, PMI premium is \$62.50, and the neighborhood association fee is \$20 per month. In addition, the borrowers have a monthly installment obligation of \$100, a minimum revolving charge payment of \$50, an auto loan payment of \$175, child care expenses of \$200 per month, and other monthly charges of \$100. They have stable jobs and good credit. Do they qualify under rules number 1 and 2?

Combined Monthly Gross Income	\$5,000.00
Housing Expenses:	
Principal and Interest	\$699.22
Property Taxes	300.00
Hazard Insurance	30.00
PMI Premium	62.50
Association Fees	<u>20.00</u>
Total:	\$1,111.72 ÷ 5,000 = 22.23% OK
Debt Expenses:	
Installment Payments	100.00
Revolving Charges	50.00
Auto Loan	175.00
Child Care	200.00
Other	<u>100.00</u>
Total:	625.00
Plus Housing Expenses	<u>1,111.72</u>
Grand Total:	\$1,736.72 ÷ 5,000 = 34.73% OK

■ **FOR EXAMPLE** A single parent's gross monthly income is \$3,000. The loan amount applied for is \$75,000 at 7.5% for 30 years with a monthly principal and interest payment of \$524.42. The property taxes are \$200 per month, insurance is \$20, and the PMI is \$60. Installment obligations are \$100 per month, the auto loan payment is \$80, child care is \$100, and other payments cost \$100 per month. Does the borrower qualify under rules 1 and 2?

Monthly Gross Income	\$3,000.00
Housing Expenses:	
Principal and Interest	\$524.42
Property Taxes	200.00
Hazard Insurance	20.00
PMI Premium	<u>60.00</u>
Total:	\$804.42 ÷ 3,000 = 26.81% OK
Debt Expenses:	
Installment Payments	100.00
Auto Loan	80.00
Child Care	100.00
Other	<u>100.00</u>
Total:	380.00
Plus Housing Expenses	<u>804.42</u>
Grand Total:	\$1,184.42 ÷ 3,000 = 39.48% Not OK

To qualify, this borrower will have to pay off some of the debt.

Fannie Mae/Freddie Mac Maximum Loan Limits

The conforming loan limit is now set by the Federal Housing Finance Agency (FHFA). The limit for 2013 and 2014 remained at \$417,000 for most areas, with a special provision for high-cost areas. These limits are set equal to 115% of local median house prices and cannot exceed 150% of the standard limit (\$417,000 in 2014 or \$625,500 for high-cost areas). According to provisions of the Housing and Economic Recovery Act of 2008 (HERA), the national loan limit is set based on changes in house prices over the previous year, but it cannot decline from year to year. New loan limits are generally published at the end of each calendar year for the coming year. For more information on current loan limits see www.hud.gov. For specific Fannie Mae and Freddie Mac loan products, see www.fanniemae.com and www.freddie.com.

Jumbo Loans

Any loan exceeding the current Fannie Mae/Freddie Mac conforming loan limits is considered a jumbo loan. Each lender is free to set their own qualifying standards, although the Fannie Mae/Freddie Mac guidelines are often used. Jumbo loans may be up to whatever amount a lender is willing to risk.

PRIVATE MORTGAGE INSURANCE

Private mortgage insurance (PMI) is required on conventional loans when the **loan-to-value (LTV) ratio** is in excess of 80% as stated in the Fannie Mae and Freddie Mac guidelines. The insurance covers the amount of the loan in excess of the 80% LTV ratio. Private mortgage insurance programs vary in the need for coverage and amount of coverage required. Rates can also vary depending on the private mortgage insurance carrier and on the credit standing of the borrower.

Mortgage insurance is issued to protect the lender in case the borrower defaults on the loan payments. If a property is foreclosed, the insurance company either pays the lender in full and acquires the property or pays the lender in accordance with the terms of the insurance plan plus expenses, and the lender acquires the property.

Although some borrowers may choose to pay part or all of the private mortgage insurance at closing, it is more common for the annual renewal fee to be paid monthly and added to the principal, interest, taxes, and insurance (PITI) payment. The annual premium is calculated as a percentage of the loan amount (generally ranging from 0.65% to 1.25%, depending on the amount of the down payment and the borrower's credit status) divided by 12 and added to the monthly mortgage PITI payment, as seen in the following.

\$100,000 fixed rate, 30-year loan with 10% down (90% LTV)

Premium: 0.75% of loan amount

Calculation: $\$100,000 \times 0.75 = \750 annual premium

$\$750 \div 12 = \62.50 added to monthly PITI payment

There are also PMI payment plans in which the costs are financed. This is accomplished by adding the lump-sum premium amount to the loan balance to be repaid over the life of the loan. There is also a plan where the lender pays the PMI, but the borrower pays a higher interest rate on the PMI portion of the loan. One advantage to the borrower is that all of the interest is deductible. The disadvantage is that the higher interest rate remains for the life of the loan.

Private mortgage insurance on loans originated between 2007 and 2012 was deductible under the Mortgage Forgiveness Debt Relief Act of 2007. The full deduction was available for families with an adjusted gross income of \$100,000 or less. Families with incomes over \$100,000 were eligible for a partial deduction. The deduction was not limited to first-time homebuyers and could be claimed for the principal residence of the taxpayer plus one other residence, such as a vacation home. The act was extended through the end of 2013. A further extension remains under consideration by Congress.

The financial crisis that began in 2007 resulted in disaster for the PMI companies, with many insurers going out of business. Despite billions of losses, four of the major companies survived and are beginning to show their first profits in several years. The private mortgage insurance business has benefited from the government loan modification programs that have prevented many foreclosures and also from the gradual shift back to conventional financing from FHA loans, which had taken over approximately 80% of the market after the housing bubble burst. The four surviving PMI companies, plus two new companies, have formed a new trade association called the U.S. Mortgage Insurers (USMI), which has replaced the Mortgage Insurance Companies of America (MICA), which closed in early 2014. Members of the new association are Arch Mortgage Insurance Ltd., Essent Group Ltd., Genworth Financial, MGIC Investment Corporation, National Mortgage Insurance Corp., and Radian Group Inc.

PMI Guidelines

In response to the declining market in 2007, private mortgage insurers re-evaluated their guidelines for approval. From time to time, a PMI company may designate certain states as severely declining and enforce additional underwriting restrictions. Factors that can be affected are the minimum credit score, the maximum loan amount, and the debt-to-income ratio.

The Federal Housing Finance Agency (FHFA), as conservator for Fannie Mae and Freddie Mac, is working with the GSEs to revise, expand, and align their risk management requirements in order to incorporate a new, risk-based framework that will ensure a sufficient level of liquid assets is always available to pay claims. According to MICA, the PMI companies paid over \$22 billion in claims to Fannie Mae and Freddie Mac, reducing taxpayer liability by over 14% during the recent crisis period.

Termination of PMI Payments

PMI premiums continue until the lender releases the coverage, which depends not only on the increased equity position of the borrower, but on the payment history as well. Once the LTV ratio reaches 80%, the insurance company is no longer liable for any losses due to default by the borrower, and the insurance premium payments should stop. Usually the borrower must initiate the release.

Under the Homeowners Protection Act of 1998, PMI premiums must be terminated automatically when the LTV ratio reaches 78% of the property's original value, not its current market value. Termination is required only if the loan payments are current. Borrowers may also request to have the PMI canceled when the LTV ratio reaches 80%, if their recent payment history is unblemished and there is no other debt on the property. Fannie Mae and Freddie Mac require that mortgage lenders and servicers doing business with them automatically terminate PMI premiums on all existing loans that are halfway through their term. They also require lenders to drop the PMI once a homeowner reaches 20% equity. They calculate this figure by including the value of the home improvements and market appreciation. However, this approach is not automatic. The borrower must have a record of timely payments and formally request such an action.

Split or Piggy-Back Loan

One way for a borrower to avoid paying a PMI premium is called a **split loan** or a **piggy-back loan**, involving a first and second mortgage executed simultaneously. The arrangement can be for an 80/10/10 split, an 80/15/5 split, or even an 80/20/0 split, although this would be rare today. In each case, the first mortgage remains at 80% LTV, which requires no PMI. The second number represents a second mortgage that is held by the same lender but at a slightly higher rate and shorter term. The last number represents the down payment. The actual monthly payment may be less than it would have been with a 95% or 97% LTV, and all of the interest is deductible. For refinancing purposes, the sum of the two mortgages is considered the original loan amount.

REFINANCING EXISTING CONVENTIONAL LOANS

With mortgage interest rates at relatively low levels for the past few years, many homeowners have considered refinancing their existing loans as a method for saving money by lowering their monthly payments. The amount of this saving may not be cost-effective for everyone, however. The costs of refinancing are unregulated and vary dramatically among lenders. A new loan may require an application fee, title insurance, an appraisal, an attorney, and probably some discount points where one point equals 1% of the loan amount. It is important to determine the total costs before making a decision to refinance.

For example, assume a balance exists on a 30-year amortizing loan of \$100,000 at 8% with a monthly payment of \$733.77, including principal and interest. To refinance this amount with a new 30-year loan at 7% interest will require a monthly payment of \$665.31, a savings of \$68.46 per month. If the cost of securing this new financing total is \$3,500, it will take about 51 months to recover the costs ($\$3,500 \div \$68.46 = 51.12$ months). It is generally accepted that a rule-of-thumb to use in analyzing the advisability of refinancing is that the costs of the new loan should be recovered over a two-year to three-year period. Thus, when the owner continues to occupy the property for a longer period of time, a savings will be achieved.

Before making the decision, it is important to discuss a loan modification with the existing lender. It may offer a lower interest rate with minimal transaction fees eliminating the need for refinancing. In an effort to help homeowners avoid foreclosure, several new

refinancing programs were introduced in 2008 as part of the Making Home Affordable (MHA) initiative. The most recent plan for refinancing is the Home Affordable Refinancing Program (HARP).

The monies received from refinancing, even if they exceed the price paid for the property, are known as realized capital gains and are not taxable until they become recognized capital gains when the property is sold.

Streamlined Modification Program (SMP)

In November 2008, the FHFA announced a **Streamlined Modification Program (SMP)** that Fannie Mae and Freddie Mac could offer to seriously delinquent borrowers in an effort to prevent foreclosure. The SMP allows a lender to modify an existing loan to provide the borrower with an affordable monthly payment at no more than 38% of gross monthly income. This can be done by reducing the interest rate, extending the term to 40 years, or forbearing part of the principal. The program was available for borrowers who occupy the property as a permanent resident, have missed at least three monthly payments on loans that were originated on or before January 1, 2008, and have not filed for bankruptcy. The loan-to-value (LTV) ratio must be at least 90% based on an appraisal, a valuation provided by Fannie Mae or Freddie Mac.

In March 2013, the FHFA announced a new Streamlined Modification Initiative, which requires eligible borrowers to make three on-time trial payments, after which the mortgage will be permanently modified. The program went into effect July 1, 2013, and expires August 1, 2015. Requirements of the new plan are as follows:

1. The loan must be owned or guaranteed by Fannie Mae or Freddie Mac.
2. The loan must be 90 days to 24 months delinquent.
3. The first-lien mortgage must be at least 12 months old with an LTV equal to or greater than 80%.

Loans that have been modified at least two times previously are not eligible. The key difference from the original SMP program is that borrowers will not be required to document their hardship or financial situation.

Home Affordable Modification Program (HAMP)

On March 4, 2009, the Home Affordable Modification Program (HAMP) was introduced as a part of the Making Home Affordable Program. The Treasury department partnered with financial institutions to reduce homeowners' monthly payments to a 31% front-end ratio. Special incentives were offered to both loan servicers and borrowers under this program. In order to be eligible, the borrowers must

- be delinquent on the mortgage or at imminent risk of default,
- occupy the property as a principal residence, and
- have a mortgage that originated on or before Jan. 1, 2009, with an unpaid balance of less than \$729,750.

The lender may take the following steps for an eligible borrower to achieve the 31% ratio:

- Reduce the interest rate to as low as 2%
- If necessary, extend the loan term to 40 years
- If necessary, defer a portion of the principal until the loan is paid off, waiving the interest on the deferred amount
- Elect to forgive principal in order to achieve the target monthly payment

As of June 1, 2012, the HAMP program was expanded to include

- homeowners who currently rent their home,
- homeowners who did not previously qualify for HAMP because their debt-to-income ratio was 31% or lower,
- homeowners who previously defaulted on a HAMP trial period, and
- homeowners who previously defaulted on a HAMP modification.

The HAMP program has been extended through the end of December 2015.

Homeowners may also be eligible for the Home Affordable Refinance Program (HARP) subject to the following criteria:

- The mortgage must be owned or guaranteed by Freddie Mac or Fannie Mae.
- The mortgage must have been sold to Fannie Mae or Freddie Mac on or before May 31, 2009.
- The mortgage cannot have been refinanced under HARP previously.
- The current loan-to-value ratio must be greater than 80%.
- Borrowers must be current on their mortgage with a good payment history for the past 12 months.

A limited number of lenders have chosen to participate in HARP 2.0, which has the following revisions:

- There is no longer a 125% LTV cap.
- Borrowers with mortgage insurance can refinance.
- Appraisals are waived with most Fannie Mae loans and some Freddie Mac loans.
- A low credit score is accepted if automated underwriting approves it.
- The debt-to-income ratio can be up to 50%.

The HARP program is scheduled to end on December 31, 2015.

For more information, see www.makinghomeaffordable.gov and www.hmpadmin.com.

SUBPRIME AND PREDATORY LENDING

In the financial world, mortgage loans are designated as A, B, C, or D paper. Ideally, all borrowers would be rated “A.” There are cases, however, where the loan is considered “B” quality—showing definite credit problems; “C” quality—indicating borrowers with very marginal or poor credit; or even “D” quality—indicating a very high risk on the loan. A category of “A minus” may be used to describe those applicants who are very close to “A” but have minor credit or qualifying problems. Lenders who provide loans or even specialize in the B, C, or D paper are called **subprime lenders**.

Subprime lending is credited with making home ownership possible for many immigrants, first-time homebuyers, and those suffering from temporary financial setbacks and was a contributing factor to the record 69% rate of homeownership reached in 2004. Unfortunately, the percentage of homeownership has been slowly declining as a result of the increased rate of foreclosures occurring throughout the country. Overuse of subprime lending products is also considered to have been a contributing factor to the downfall of the mortgage lending market, beginning in 2007.

In the Center for Responsible Lending’s *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures* report, it is stated that of mortgages made between 2004 and 2008, 6.4% have ended in foreclosure and that another 8.3% are at risk (see www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-2011.pdf). The report also says that foreclosure rates are consistently worse for borrowers who received high-risk loan products largely promoted by the subprime market (e.g., loans with prepayment penalties, hybrid adjustable-rate mortgages, and option ARMs).

The terms *subprime* and *predatory* are not synonymous. Subprime loans are made to persons with less-than-perfect credit ratings and usually carry higher interest rates and fees than the prime loans offered to applicants with no credit problems.

A subprime loan may range from 1 to 5% above the current market rate, depending on the extent of the potential borrower’s credit problems. Borrowers should beware of predatory lending when the quoted interest rate is in excess of these percentages or the rate seems competitive but the annual percentage rate (APR) is much higher than the quoted rate.

There has always been a need for a subprime market to meet the needs of special case buyers who do not qualify for traditional mortgage loans. Unfortunately, the rapid expansion of the subprime market to thousands of homebuyers who did not fully understand the implications of possible future changes in the amount of monthly payment due led to financial disaster for both the borrowers and the subprime lending companies.

Predatory Lending

Billions of dollars are lost by consumers every year due to predatory mortgages, payday loans, and other lending abuses, such as overdraft loans, excessive credit card debt, and tax refund loans. HUD, VA, Fannie Mae, Freddie Mac, the Mortgage Bankers Association, and the Association of Mortgage Professionals have all worked very hard to combat the prevalence of predatory lending. Unfortunately, the predatory lender may be someone well-known and trusted by the potential borrower. It is suggested that a borrower check out any lender being considered with the local Chamber of Commerce, the Better Busi-

ness Bureau, and either the Mortgage Bankers Association or the Association of Mortgage Brokers. The problem is especially difficult when the borrowers do not speak English and are literally being preyed upon by a lender of their particular ethnic-language group.

Predatory lending is generally defined as the practice of charging interest rates and fees that are higher than justified by risk-based financing. Fees on a typical mortgage loan average around 1%; on a predatory loan, fees totaling 5% or more are common. Because points and fees can be financed as part of the loan, they may be disguised or downplayed by the lender. Often, borrowers are placed in a loan that is not only expensive in terms of rate and fees, but it may also be difficult, if not impossible, to pay back. The result can be the loss of the home or continued refinancing of the loan, called loan flipping. Another common practice is charging abusive prepayment penalties. Only a small percentage of regular home loans contain any prepayment penalty, but the predatory lender may include a prepayment clause in the note that prohibits the borrower from paying off this high-interest loan for three years or more and charges more than six months' interest as a penalty. One of the most reprehensible forms of predatory lending is where a lender entices a homeowner to take out a home equity loan, knowing full well that there is no way that the loan can be repaid and that it will eventually lead to foreclosure on the property.

In communities across America, borrowers have lost their homes because of the actions of predatory lenders, appraisers, mortgage brokers, and home improvement contractors. Other predatory lending practices include

- lending on properties for more than they are worth using inflated appraisals;
- encouraging borrowers to lie about their income, expenses, or cash available for down payment;
- knowingly lending more money than a borrower can afford to repay;
- charging high interest rates to borrowers based on their race or national origin;
- charging fees for unnecessary or nonexistent products and services;
- pressuring borrowers to accept higher-risk balloon or interest-only loans, or loans with steep prepayment penalties or possible negative amortization;
- stripping homeowners' equity from their homes by convincing them to refinance again and again when there is no benefit to the borrower;
- using high-pressure sales tactics to sell home improvements and single-premium mortgage insurance; and
- steering the borrower into a subprime mortgage when the borrower could have qualified for a mainstream loan. Fannie Mae has estimated that up to one-half of borrowers with subprime mortgages could have qualified for loans with better terms.

Two types of loans that are not necessarily predatory but could be if the borrower does not understand the implications of the loan are the following:

- Balloon loan requiring full payment at the end of the initial term
- Interest-only loan with balance of principal plus interest due at end of term

Mortgage Fraud Red Flags and Best Practices for Prevention¹

It is important for real estate professionals to be aware of common fraud schemes to help protect their clients and their business.

Foreclosure Rescue Scheme. This type of fraud takes advantage of homeowners who have fallen behind on their monthly mortgage payments. Some of the red flags to look out for are:

- The borrower is buying the property as an investment while continuing to rent.
- The borrower is buying multiple rental properties simultaneously.
- The borrower is buying the property as a primary residence while already owning a home of a higher value.
- The borrower is unable to contribute to funds to close.

False Stated Income Fraud. In a stated income loan, the income that is put on the loan application is not fully verified. In a false stated income loan, the borrower's income is misstated for qualification purposes. Use the following best practices to help all of the parties to the transaction avoid this type of fraud:

- Try to ensure that the most experienced underwriters on the lending team underwrite stated income loans.
- Review the borrower's age, education, experience, and job position, and then compare them against the income listed on Form 65.
- Evaluate the borrower's accumulation of assets and consider the borrower's debt.
- Refer to online tools and databases that provide income and employment data by zip code.
- If a W-2 wage earner is qualifying under a stated income program because the borrower has additional income that is not documented, Form 65 should specifically state which portions of the borrower's income are earned from each source.
- If the borrower does not qualify based on traditional income documentation, the originator may not place the borrower into a stated income loan.
- The income of a non-qualifying spouse or partner should never be added to the borrower's income for qualifying purposes under a stated income loan.

¹ Source: <http://www.freddiemac.com/singlefamily/preventfraud/redflags.html>

Cash-Out Purchases and Illegal Property Flipping. Property flipping with a cash-out purchase becomes fraudulent when a buyer/borrower approaches the seller with an offer that is considerably higher than the list price. The offer will include a stipulation that the additional amount over the list price will be given to the buyer/borrower at closing. An inflated value charged to non-existent home improvements will be used to support the inflated sales price. Although difficult to detect, some of the red flags to look out for with this type of scheme are:

- The home may have been on the market for an extended period of time.
- The sales contract may have been modified or may include an addendum regarding the payment to the borrower.
- The appraisal may include red flags symptomatic of inflated value.
- Many of the red flags that are found with a traditional flip also apply to this type of fraud (e.g., straw buyer, false source of funds, and false occupancy).
- The preliminary HUD-1 form may already indicate a portion of the net proceeds going back to the borrower.

State Legislation and Predatory Lending

Many states have initiated predatory lending legislation. The first of these was North Carolina in July of 1999. Other states soon followed, and today almost every state, including the District of Columbia, has some type of antipredatory lending law. Unfortunately, these laws vary greatly from state to state, creating compliance difficulties for large national lenders. Specific updated information by state can be found on the Mortgage Bankers Association website at www.mbaa.org.

Federal Legislation and Predatory Lending

Other than the traditional Real Estate Settlement Procedures Act (RESPA), Truth in Lending Act (TILA), and Homeowner and Equity Protection Act (HOEPA), there has been little federal legislation specifically prohibiting predatory lending. The new Consumer Financial Protection Board will be taking steps to address the problems of predatory lending in all areas of personal finance.

HUD has taken action to combat one form of predatory lending in HUD 24 CFR Part 203 “Prohibition of Property Flipping” in HUD’s Single Family Mortgage Insurance programs. This regulation was passed to prevent a home being purchased with an FHA-insured loan and then flipped within a short period of time for a considerable profit. In some cases, this was being done with collusion between the lender and an appraiser.

In May 2010, in an effort to speed the sale of foreclosed homes, FHA dropped the 90-day requirement as long as the property is being sold by a lender after foreclosure.

VARIATIONS IN FORMATS

The deed of trust, note and mortgage, and contract for deed are flexible and, therefore, adaptable to many situations by using creative design. Almost every realty financing contingency can be solved to the satisfaction of all the participants. Not only can specific terms and conditions be designed to meet particular requirements, but special forms of these three lending instruments can also be developed to finance unique real estate situations.

Open-End Mortgage

An open-end mortgage allows a borrower to secure additional funds from a lender—funds that, in many instances, represent the principal already paid by the borrower. The funds advanced by this process are repaid by either extending the term of the mortgage loan or increasing the monthly payments by the amount appropriate to maintain the original amortization schedule. The interest rate can also be adjusted accordingly, and appropriate fees can be charged.

Open-end mortgages are often used by farmers to raise funds to meet their seasonal operating expenses. Similarly, builders use the open-end mortgage for their construction loans in which advances are made periodically while the building is being completed. In addition, many private loan companies are offering customers an opportunity to draw down on a line of credit backed by the collateral of their home equity.

A basic legal problem associated with open-end financing is one of securing future advances under an already existing debt instrument and, at the same time, preserving its priority against any possible intervening liens. For example, an advance made under a construction mortgage that sets forth a specific pattern of draws is interpreted to have priority over a construction (mechanic's) lien that may have been filed in the period prior to the last advance.

Under the laws of those states that have adopted the Uniform Commercial Code, any personal property security agreements for the purchase of goods that become fixtures on the collateral property have a priority lien over future advances made under an original mortgage. Suppose a homeowner signs a financing contract to purchase and install a central air-conditioning system in June, and the agreement is recorded. In December, the owners secure an advance on their open-end mortgage to build an addition to their home. Because the central air-conditioning system is now a fixture, the appliance company's lien will take priority over any future advances made by the original mortgagee.

Construction Mortgage

A construction mortgage, also called an interim financing agreement, is a unique form of open-end mortgage. It is a loan to finance the costs of labor and materials as they are used during the course of constructing a new building. An interim mortgage usually covers the period from the commencement of a project until the loan is replaced by a more permanent form of financing at the completion of construction. This financial format is unique because the building pledged as part of the collateral for the loan is not in existence at the time that the mortgage is created. The value of the land is the only available

collateral at the loan's inception, a condition that requires the lender to seek some form of extra protection.

The procedure for protecting the lender is both logical and practical. Although the full amount to be loaned is committed at the start of construction, the funds are distributed in installments as the building progresses, not as a lump sum in advance. The outstanding loan balance is matched to the value of the collateral as it grows.

Application and Requirements. To obtain a construction loan, the borrower submits plans and specifications for a building to be constructed on a specific site to a loan officer for analysis. Based on the total value of the land and the building to be constructed thereon, a lender will make a commitment for a construction loan, usually at the rate of 75% of the property's total value.

For example, a \$100,000 project would be eligible for a \$75,000 construction loan. This amount normally would be adequate to cover most of the costs of construction, with the \$25,000, or 25% equity, representing the value of the free and clear lot. In a case where the lot is encumbered by an existing mortgage, the mortgagee must subordinate that interest to the lien of the new construction mortgage before the loan can be granted.

Construction loans are available for projects of all sizes, and the charges imposed vary according to the lender. Typically, there is at least a 1-point placement fee plus interest at 2 points above the prime rate charged to AAA-rated borrowers. Interest rates and placement fees fluctuate as a function of business cycles, borrowers' credit ratings, and individual situations.

Pattern of Disbursements. Disbursement of funds under a construction loan usually follows one of two basic patterns. A construction loan may be designed to include a schedule for disbursing funds in a series of **draws** as construction progresses. In a five-stage plan, an interim financier distributes 20% of the funds each time the building reaches another one-fifth of completion.

In the \$75,000 example, \$15,000 is distributed to the builder when the first stage is accomplished, with subsequent \$15,000 draws until completion, when the final draw is paid. This final \$15,000 might be withheld pending the full payment of all labor and materials as evidenced by lien waivers from each of the contractors and subcontractors of the job, receipt of a certificate of completion and approval for occupancy issued by a building inspector, or expiration of the statutory time to file a construction lien.

Another pattern of disbursement under a construction loan requires the borrower to submit all bills for subcontracted labor and materials to the lender, who then pays these bills and charges the loan account accordingly. This plan gives the lender greater control over the possibility of intervening construction liens.

The pattern of disbursement, in the form of either draws to the builder or direct payments from the lender, effectively matches the value of the collateral to the amount of the loan outstanding at a particular time. If there is a default at any point during construction, the lender can foreclose and recover the collateral in its unfinished condition. It can then be sold "as is" or completed to recover the investment.

Interest is charged on these monies only after they are disbursed following each inspection of the work's progress. The accumulated interest charges and the entire construction loan principal are paid in full within some relatively short period of time after completion

of the project. Usually, a construction loan is replaced by a permanent, long-term senior loan for which the builder has arranged in advance.

Lender Protection. There are no insurance plans for guaranteeing the payments on construction loans. As additional protection, many construction financiers insist their borrowers/builders secure a **completion bond** from an insurance company, naming the lender as the primary beneficiary. The bond is drawn in the amount of the total construction cost and is exercised only if the builder is unable to complete the construction. Under this circumstance, the lender can step in and use the bond proceeds to pursue the completion and subsequent sale of the property to recover the interim loan funds. Often small building companies cannot qualify for bonding and must pledge other assets as additional collateral for a construction loan.

Construction loans are drawn for relatively short time periods—six months to a year for a house and up to three years for larger projects. The interim lender needs to be paid in full at the end of these periods and is vitally concerned with making provisions in advance for the security and satisfaction of the construction loan. The borrower is equally concerned with this payback and is eager to be relieved of the heavy interest burden imposed during the loan period. Therefore, provisions for a permanent, long-term mortgage are made prior to the origination of the construction loan to satisfy or “take out” the interim financier at the completion of construction.

Sources of Funds. The relatively short-term nature of construction loans closely matches the investment profile of commercial banks, which take an active role in this form of financing. However, some lenders that generally deal in long-term loans also participate in interim financing. For example, they will provide money for construction and then simply convert these interim mortgages to permanent mortgages for eligible borrowers. In other words, these lenders have created an in-house loan package, called a construction/permanent loan.

While construction loans are tailored to the investment needs of commercial banks, permanent long-term takeout loans match the investment designs of thrift institutions and life insurance companies. All types of investment groups can participate in the various stages of construction financing.

Blanket Mortgage

Depending on the terms of a specific transaction, a lender may require a borrower to pledge more than one parcel of property as collateral to back up a mortgage. The debt instrument used in this situation is called a **blanket mortgage** and can take any of the financing forms discussed previously. When the properties encumbered by a blanket mortgage are located in more than one county, the debt instrument must be reproduced and recorded at the courthouse in each county where a subject property is located.

Release Clause. When two or more properties are pledged as collateral for one loan, it is often necessary to provide some means for relinquishing an individual parcel as payments are made. Such a tool is called a release clause. In exchange for some action, such as a designated amount of repayment, a specific property or portion of a property can be freed from the lien of a blanket mortgage.

Blanket mortgages are often used to purchase large tracts of land for development, and a release clause usually is incorporated into these financing instruments. The absence of a release clause requires the payment in full of the entire balance due before any portion of the land can be sold lien free. The alternative is to sell a portion of the land without satisfying the underlying blanket mortgage or contract for deed. This latter technique could create many difficulties for the buyer of a small parcel. If the payments on the underlying encumbrance are not made on time by the developer, the small parcel owner may be wiped out in a foreclosure. Unfortunately, some early land promotion developments in this country were designed on this no-release basis, with concurrent losses to individual buyers.

Recognition Clause. Most responsible land developers secure a special recognition clause from their underlying financiers that protects individual small parcel owners. This clause specifies that in the event of a default and a resultant foreclosure, the underlying financier will recognize and protect the rights of each individual lot owner. Many states require not only full disclosure of the physical attributes of the land involved in such a development but also a description of all financing terms. These state disclosure laws closely parallel those of the federal government for interstate land sale promotions.

Leasehold Mortgage

Tenants are able to pledge their leasehold interests as collateral for leasehold mortgages. Some of these mortgages are eligible for FHA and VA insurance and guarantees, and national banks have been authorized to make such loans provided that the lease term extends for a sufficient interval after the expiration of the leasehold mortgage.

The major sources of funds for leasehold mortgages are life insurance companies, mutual savings banks, and commercial banks. Any primary lender must be in first priority lien position so that full title to the collateral property may be secured in the event of a default. Thus, a leasehold mortgage arrangement usually includes the landlord's pledge of the legal fee in the property as well as the tenant's pledge of the improvements as collateral for the loan. The landlord's pledge of the fee simple legal rights in the land is called subordination.

As a consequence, if a loan default occurs that necessitates a foreclosure action, a lender will be protected by having the legal right to recover both the land and the building. Most leasehold mortgages are designed to include both land and buildings as collateral, requiring the landlord's subordination of the legal fee to the new lien.

Package Mortgage

When personal property is included with the sale of real estate, it is possible to use a single financing instrument called a **package mortgage**. It includes as collateral not only the real estate but certain fixtures attached to the property and/or other items of personal property described in the mortgage document. Most installations, such as heating units, plumbing fixtures, and central air systems, when attached to the real estate, become real property and are automatically included under the lien. However, other fixtures not normally considered real property, such as ranges, ovens, refrigerators, freezers, dishwashers, carpets,

and draperies, may be included in a home purchase financing agreement to attract buyers. This inclusion will enable homebuyers to stretch the payments for these items over the entire term of the mortgage, as opposed to the shorter term of a consumer installment loan.

An additional incentive to use the package loan is that the interest on a home loan is tax deductible whereas the interest on a consumer loan is not. Many commercial rental properties, including condominiums, apartment rentals, office buildings, and clinics are specifically designed to include package financing.

Manufactured Housing Mortgage

In 1974, HUD was designated as the agency to oversee the Federal Manufactured Housing Program. All **manufactured housing** (formerly known as mobile homes) must be built to HUD standards in a controlled atmosphere manufacturing plant. The structures are then transported in one or more sections on a permanent chassis to a building site.

Are manufactured homes real or personal property? The lender is obviously concerned that there is sufficient collateral to justify financing the purchase of the home. There is little doubt that a travel trailer attached by a hitch to an automobile or set onto the bed of a pickup truck or a van-type travel home is clearly identifiable as personal property. Many larger homes manufactured as factory-built housing units are legally transportable only by professional movers. These units are permanently attached to lots in rental parks that cater to long-term tenancies or are installed on property purchased by the owner of the home. When long-term leases are involved or a homeowner has title to the lot on which the unit is permanently affixed, real estate financing is possible. Most manufactured homes are eligible for FHA or VA financing.

Purchase-Money Mortgage

The term *purchase-money mortgage* is usually used to refer to when a seller carries back a portion or all of the sales price as a loan to a buyer. A purchase-money mortgage can be either a senior or junior lien on the property.

Bridge Loan

A bridge loan is an equity loan designed to serve a specific purpose, usually for a relatively short period of time. For example, owners of one property wishing to purchase another might seek a short-term bridge loan on their equity to be able to close the purchase. This loan would be satisfied when the old property was sold or at a specified time, whichever came first. The bridge loan is usually an interest-only term loan, requiring a balloon payment at its conclusion.

Wraparound Loan

A wraparound loan is a special instrument created as a junior financing tool that encompasses an existing debt. Adopting any of the three basic financing forms, these encumbrances are used in circumstances where existing financing cannot be prepaid easily due

to a lock-in clause or a high prepayment penalty. They are also used where the interest rate on the existing mortgage allows a lender to secure a higher yield by making a wrap loan.

■ **FOR EXAMPLE** The sale of a \$100,000 property with a \$10,000 cash down payment and an assumable first mortgage balance of \$70,000 at 6% interest can only be financed by a seller who would carry back a new wraparound loan for \$90,000 at 7% interest. This wraparound would require the purchaser/mortgagor to make payments on the \$90,000 of \$6,300, while the seller/wraparound-mortgagee would retain responsibility for making the required payments on the undisturbed existing \$70,000 first mortgage of \$4,200, leaving \$2,100 as a yield on the \$20,000 wrap equity or 11%.

The use of the wrap has diminished dramatically as most existing real estate loans cannot be easily assumed. Some lenders might offer their borrowers an opportunity to secure additional funds on the equities in their properties at less-than-market interest rates by arranging to wrap the existing loans at a one-point or two-point override.

Option to Buy

An option to buy gives the buyer, also known as the optionee, the absolute right (but not the obligation) to acquire certain real estate during the option period, provided the option payments are kept current.

Lease with Option to Buy

A variation of the option to buy is a **lease option** to buy. In this case, the buyer agrees to purchase the property at a price negotiated within the lease. Often, a portion of the rent is applied to the purchase price as an incentive for closing the transaction. Contemporary lease-options include a **right of first refusal** clause instead of an outright option. Here, the price is not fixed at the outset; market conditions dictate the final value to be accepted by both parties. A variation that is regaining popularity since it has become more difficult to obtain mortgage financing is the **lease purchase**. Unlike the lease-option, there is an actual sales contract that includes the sales price, provisions for the amount of rent to be paid, any credit to be given back to the purchaser at time of settlement, and a projected settlement date. Financing is usually arranged 30 to 60 days prior to the projected settlement date.

PARTICIPATION AGREEMENTS

Mortgage Participation

There are three types of mortgage participation. One is a partnership among several mortgagees, a second includes the teaming of several mortgagors, and a third establishes a partnership between a mortgagee and a mortgagor.

Partnership of Mortgagees. In the first type, a mortgage participation involves more than one mortgagee as the owner of the instrument designed to finance a real estate project. It is used in large project financing. Several mortgagees join together, each advancing a proportionate share of the monies required and receiving a commensurate share of the mortgage payments.

Mortgage-backed securities are in reality a form of mortgage participation. Individual investors may purchase shares in a designated group, or pool, of mortgages (e.g., Ginnie Mae guarantees mortgage-backed securities or other real estate mortgage investments conduits [REMICs]).

In addition to the private partnerships among several mortgagees on a single loan and the Ginnie Mae mortgage-backed securities program, real estate mortgage trusts (REMTs) also offer opportunities for mortgage partnerships. Trusts are formed where investors purchase beneficial shares under special terms. Using the pool of monies acquired by the sale of these beneficial interests, mortgage trust managers invest in real estate mortgages and distribute the profits according to a prearranged formula. The private ownership quality of REMTs allows them to invest in high-risk loans such as junior loans or construction financing. Sometimes, as a result of adverse financial conditions, REMTs are inadvertently converted to real estate investment trusts (REITs) when they foreclose on their delinquent mortgagors and end up owning the properties they financed.

Partnership of Mortgagors. The second type of mortgage participation involves several mortgagors sharing responsibility for a single mortgage on a multifamily property, called a cooperative.

A cooperative vests ownership in a corporation that issues stock to all purchasers, giving them the right to lease a unit from the corporation. This proprietary lease is drawn subject to the rules and restrictions established by the corporation, and management is in the hands of a board of directors elected by the stockholders. The major weakness of the cooperative form of mortgage participation is that each cooperative participant is dependent on the other owners to prevent a default of the mortgage. A financially irresponsible tenant or units that remain unsold for long periods create a financial strain on the remaining tenants who are still liable for making the total mortgage payments.

Partnership of Mortgagees and Mortgagors. The third type of participation, called a participation mortgage, is engendered when a mortgagee becomes a partner in the ownership of a project on which a loan will be placed. When a developer requests a commitment for a participation mortgage on a substantial commercial real estate project, a lender may accept a higher loan-to-value ratio, lower the interest rate, or make other concessions in return for a percentage of the project's ownership as a condition for issuing the loan commitment. These mortgagee ownerships range from 5 to 50% or more and simultaneously make the lender a partner in the development as well as its financier.

Shared Appreciation Mortgage

Lenders sometimes can expand their earning possibilities by participating in a real estate transaction as both owners and financiers. In addition to the Shared Appreciation Mortgage (SAM), where the lender reduces the initial interest rate in exchange for a share of the property's future increased value, there are other variations of this type of participation financing.

Joint Ventures

The most complete form of equity participation is a joint venture, in which the lender puts 100% of the funds needed for a development up front in exchange for the expertise and time of the developer. The lender then becomes an investor in full partnership with the developer.

Some joint venture partnerships are expanded to include the landowner, the construction company, the financier, and the developer, who supervises the entire project from its inception until it is completely rented and sometimes even beyond as a permanent manager. Passive investors in joint venture partnerships cannot use a loss from passive investment to protect their active income.

Sale-Leaseback

The sale-leaseback is a useful tool of real estate finance and is used primarily for larger projects. In this situation, the owner of the property sells it to an investor and leases it back at the same time. This financing arrangement is used when companies with considerable cash tied up in their real estate want to free this capital for more speculative ventures. The lease used for this method is usually a fully net lease that extends over a period long enough for the investor to recover invested funds and to make a fair profit on the investment.

The sale-leaseback approach to real estate finance is generally applied to commercial properties because rents paid by businesses and professional persons are deductible expenses in the year in which they are incurred. Using this approach, a seller/lessee enjoys many benefits, including the following:

- The seller/lessee retains possession of the property while obtaining the full sales price, in some cases keeping the right to repurchase the property at the end of the lease, in effect freeing capital frozen in equity.
- The seller/lessee maintains an appreciable interest in realty that can be capitalized by subleasing or by mortgaging the leasehold.
- The seller/lessee gets a tax deduction for the full amount of the rent, equivalent to being able to take depreciation deductions for both the building and the land.

The cash secured from the sale might be used for plant expansion, remodeling, or investing in other opportunities. In addition, a lease appears as an indirect liability on a firm's balance sheet, whereas a mortgage shows up as a direct liability and adversely affects the firm's debt ratio in terms of obtaining future financing.

The advantages to the investor/landlord in this type of arrangement include a fair return *on* and *of* the investment in the form of rent during the lease term and ownership of a depreciable asset already occupied by a good tenant. In other words, the investor is buying a guaranteed income stream that can mostly be sheltered through the proper use of interest and depreciation allowances. When determining the rent to be paid on the lease, the investor can actually manage the risk by the amount of rent received. The rent for a quality tenant will normally be lower than the rent for a high-risk tenant.

When the lease includes an option for the tenant to repurchase the property at the end of the lease term, it is called a sale-leaseback-buyback. However, care must be taken to establish the buyback price at the fair market value at the time of sale. Otherwise the arrangement is considered a long-term installment mortgage, and any income tax benefits that might have been enjoyed during the term of the lease will be disallowed by the Internal Revenue Service. Also, a fair market purchase option can only be included if the property is a new acquisition and the lessee has never been in the title chain.

Sale-Buyback

Under this variation of the sale-leaseback technique, a lender, usually a life insurance company or a pension fund, agrees to purchase a completed project from the developer and sell it right back on an installment sale contract for deed. The lender retains legal title to the property and profits by including a kicker in the payment to cover a participation return of the investment as well as regular interest on the investment. The developer profits through 100% financing and the depreciation shelter that comes with gaining equitable title to the property.

These contracts may be designed to extend 10 years longer than a normal mortgage term, with the payments made during the time of an average mortgage loan being sufficient to repay the purchase price. The additional 10 years of payments are added compensation to the lender/participator. If a contract runs for 30 years, it might include payments for 20 years, sufficient to amortize the sales price, then continue for an additional 10 years at a higher interest rate to satisfy the kicker requirement.

Split-Fee Financing

A more common form of lender participation than the sale-buyback form is split-fee financing. In this plan, the lender purchases the land and leases it to the developer while financing the improvements to be constructed on the leasehold as well.

The land lease payments can be established at an agreed-upon base rate plus a percentage of the tenant's income above a specified point. Under this arrangement, the lender/investor benefits by receiving a fixed return on the investment plus possible overages, while maintaining residual property rights through ownership of the fee. The developer has the advantage of high leverage and a fully depreciable asset because she owns the leasehold improvements but not the land.

TAX IMPACTS IN MORTGAGE LENDING

All homeowners receive the benefit of being able to deduct the interest paid on their mortgage loan as long as they itemize deductions on their Federal Income Tax. Points paid in the year of the origination of a mortgage loan are also deductible regardless of who pays for them. The tax benefits derived when selling a home were previously described in Chapter 3.

FIGURE 7.3 Two-Party Exchange

Step 1. Balancing Equities

Property A		Property B
\$100,000	EXCHANGE PRICE	\$150,000
<u>- 60,000</u>	EXISTING MORTGAGE	<u>- 80,000</u>
40,000	OWNER'S EQUITY	\$ 70,000
<u>+ 30,000</u>	CASH REQUIRED	
\$ 70,000		

Step 2. Deriving Realized Gain

\$100,000	EXCHANGE PRICE	\$150,000
<u>- 70,000</u>	ADJUSTED BASIS	<u>- 90,000</u>
\$ 30,000	REALIZED GAIN	\$ 60,000

Step 3. Deriving Recognized Gain

(Recognized gain equals the sum of unlike properties.)

-0-	CASH RECEIVED	\$30,000
-0-	BOOT	-0-
<u>-0-</u>	MORTGAGE RELIEF	<u>+20,000</u>
-0-	RECOGNIZED GAIN	\$50,000

Step 4. Determining Tax Impact

(Taxable income is the realized gain or the recognized gain, whichever is less)

\$30,000	REALIZED GAIN	\$60,000
<u>-0-</u>	RECOGNIZED GAIN	50,000
-0-	TAXABLE GAIN	\$50,000

(Note: A will pay no tax. B will pay income tax on \$50,000.)

FIGURE 7.3 Two-Party Exchange (continued)

Step 5. Reestablishing Book Basis

	A	B
Old Basis	\$ 70,000	\$ 90,000
New Mortgage	80,000	60,000
Cash and Boot Paid	30,000	-0-
Recognized Gain	+ <u>-0-</u>	+ <u>50,000</u>
Total:	\$180,000	\$200,000
Less		
Old Mortgage	\$60,000	\$ 80,000
Cash and Boot Received	+ <u>-0-</u>	+ <u>30,000</u>
Total:	\$60,000	\$100,000
New Basis	\$120,000	\$90,000

Step 6. Allocating New Basis

Each individual will decide which portions of the individual's new basis to allocate to land and to improvements in order to establish new depreciation schedules.

Installment Sales

A special financing tool designed to postpone capital gains income taxes on properties that do *not* qualify for special exemptions available under the income tax laws is called an installment sale plan.

A gain on an installment sale is computed in the same manner as is the net capital gain on a cash sale: gross sales price minus costs of sale minus adjusted book basis equals net capital gain. However, under an installment sale, the seller can elect either to pay the total tax due in the year of the sale or to spread the tax obligation over the length of the installment contract. The installment plan allows a seller to pay tax in amounts proportionate to the gain collected each year. A seller whose tax bracket decreases over the term of an installment contract will pay less tax than if he had elected to pay the full tax in the year of the sale. This arrangement is particularly advantageous to a seller nearing retirement age who will enter a lower tax bracket during the term of the installment contract. On the other hand, there is the possibility that a seller's tax bracket could rise over the installment term, which would lead to the payment of more tax. Consequently, a seller is allowed to pay the amount of tax due on a capital gain whenever it becomes expedient during the installment contract period.

Exchanges

Another method often employed to postpone tax on capital gains is the property exchange technique. **Internal Revenue Code Section 1031** provides for the recognition of gain to be postponed under the following conditions:

- Properties to be exchanged must be held for productive use in a trade or business or for investment.
- Properties to be exchanged must be of like kind to each other; that is, their nature or character must be similar. Like kind is only limited to another income-producing property. A rental condo could be exchanged for a delicatessen; a rental town house could be exchanged for a gas station or marina. One property may be exchanged for several properties; it is not limited to one.
- Properties must actually be exchanged.

Property held for productive use in a trade or business may include machinery, automobiles, factories, and rental apartments. Property held for investment may include vacant land and antiques. Like kind includes a machine for a machine or real estate for real estate. Improvements on the land are considered to be differences in the quality of the real estate, not in the type. Thus, a vacant lot can be exchanged for a store property. Unlike property, called **boot**, is often included in an exchange and must be accounted for separately.

There are at least six basic mathematical computations involved in the exchange process:

1. Balancing the equities
2. Deriving realized gain
3. Deriving recognized gain
4. Determining tax impact
5. Reestablishing book basis
6. Allocation of new basis

These computations are illustrated by the two-party exchange recorded in Figure 7.3.

It is rare to make a straight two-party exchange. More frequently, there are three-party exchanges or more, as well as delayed (Starker) exchanges requiring definite time limits—45 days to select and 180 days to settle.

Generally, the investor who is trading up benefits by not being required to pay taxes, while the downside exchanger is taxed on gains. A prudent investment program provides for trading up during an investor's acquisition years and trading down after retirement, when tax brackets are lower.

SUMMARY

There are two general categories of real estate loans: conventional and government. There are many variations of conventional loans. Those that meet the qualifying guidelines of Fannie Mae and Freddie Mac are called conforming loans, and they may be either fixed or adjustable rate. Other types of conventional loans include jumbo, home equity, and reverse mortgages. For conventional loans with less than a 20% down payment (80% LTV), private mortgage insurance is required. Government loans include FHA insured, VA guaranteed, USDA for rural housing, and other state or local government programs.

Subprime lending meets the needs of those who do not qualify for "A" paper loans. Although not necessarily predatory, a subprime loan may become predatory when excessive interest rates or fees are charged. Another form of predatory lending exists when a lender forces a borrower into a subprime loan unnecessarily or encourages the homeowner to enter into a home equity loan with no possible hope of repayment.

There are many variations in format for conventional loans, including open-end, construction, blanket, leasehold, manufactured housing, purchase-money, bridge, and wraparound. There are also numerous ways available for both mortgage and equity participation in a purchase.

A major source of tax-free dollars becomes available through the refinancing of the equity accumulated in real property. As borrowed money, refinancing proceeds are not taxable income but will be taxed when the property is sold.

A useful commercial property financing arrangement is the sale-leaseback. This plan involves selling real estate to an investor and, at the same time, leasing it back. As an alternative to financing a large commercial real estate development, some financiers participate in the profits by purchasing the entire project and then reselling it to the developer on a long-term installment contract. Probably the most complete example of equity participation is the joint venture, in which a financier joins with a developer as a full partner in a commercial project.

There are numerous tax advantages to owning real estate, including installment sales and Internal Revenue Code Section 1031 exchanges.

INTERNET RESOURCES

Department of Housing and Urban Development, Predatory Lending
http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfb/pred/predlend

Fannie Mae
www.fanniemae.com

Freddie Mac
www.freddiemac.com

Internal Revenue Code Section 1031
www.irs.gov

Manufactured Housing Institute (MHI)
www.manufacturedhousing.org

U.S. Mortgage Insurers
www.usmi.com

REVIEW QUESTIONS

1. Traditionally, the *MOST* popular type of mortgage loan is the
 - a. 15-year fixed rate.
 - b. 30-year fixed rate.
 - c. adjustable rate.
 - d. interest only.
2. Current legislation requires that private mortgage insurance be automatically dropped when the equity position reaches what percentage of the property's original value?
 - a. 20
 - b. 22
 - c. 78
 - d. 80
3. A couple is purchasing a \$300,000 home. In order to avoid paying private mortgage insurance, they have opted for an 80/15/5 split loan. Their second mortgage will be in the amount of
 - a. \$15,000.
 - b. \$45,000.
 - c. \$60,000.
 - d. \$240,000.
4. Using standard Fannie Mae/Freddie Mac qualifying ratios of 28/36, a couple with a combined annual income of \$80,000 would be allowed what total amount to cover all housing expense plus long-term debt?
 - a. \$1,867
 - b. \$2,400
 - c. \$22,400
 - d. \$28,800
5. A subprime lender is one who
 - a. specializes in "A" quality mortgage loans.
 - b. offers below-prime interest rate loans.
 - c. is also called a predatory lender.
 - d. makes higher-interest rate mortgage loans available to those with poor credit.
6. Refinancing is generally worth considering when
 - a. the market rate has dropped by any amount.
 - b. the market rate has dropped 2%.
 - c. bank offers no closing costs.
 - d. the cost of the new loan can be recovered in two years or less.
7. An adjustable-rate mortgage based on a LIBOR index of 4%, with a margin of 2%, note rate of 6%, and initial rate of 3.5% with 2/6 caps, could increase to what rate in a five-year period?
 - a. 4%
 - b. 6%
 - c. 9.5%
 - d. 11.5%
8. An elderly couple has lived in their home for more than 30 years. The husband and the wife are both in their 70s and have experienced extremely large medical bills. They desperately need cash. A feasible solution for them could be
 - a. an ARM.
 - b. a RAM.
 - c. a GPM.
 - d. a GEM.
9. Funds are dispersed on a construction loan
 - a. at settlement.
 - b. on completion of the building.
 - c. in increments called draws.
 - d. whenever requested by the builder.
10. An individual is selling her home to a young couple. The couple has agreed to pay her \$10,000 as a down payment. They will also pay her a total of \$6,000 per year at 8% interest for ten years. The young couple and the seller have transacted which of the following?
 - a. An option to buy
 - b. A lease with an option to buy
 - c. An installment sale
 - d. A Section 1031 exchange

11. An individual has agreed to buy a farmhouse for \$60,000. He will pay \$500 per month rent for one year with a credit back to him of \$200 per month, payable at time of settlement on the property. The buyer and the seller have executed
 - a. an option to buy.
 - b. a lease-purchase.
 - c. a right-of-first-refusal.
 - d. a Starker exchange.
12. Which condition is *NOT* required in an Internal Revenue Code Section 1031 exchange?
 - a. Properties exchanged must be held for productive use in trade or business.
 - b. Properties exchanged must be of like kind.
 - c. Properties exchanged must be of equal value.
 - d. Properties must actually be exchanged.
13. The owner of a 15-acre parcel of land, a local real estate developer, the owner of a construction company, and the president of a savings association are making plans for a new shopping center to be located near the edge of town. They are *MOST* likely entering into a
 - a. shared-appreciation mortgage.
 - b. sale-buyback.
 - c. split-fee financing.
 - d. joint venture.

Government Loans

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- explain the most important components of the major FHA programs;
- calculate the down payment and loan amount for an average-priced home;
- calculate the complete PITI plus MIP payment for a given loan amount;
- determine how eligibility for VA entitlement is derived;
- list the options available if a property appraises at less than the sales price; and
- describe the assumption process for a VA loan, including release of liability and substitution of entitlement.

allowable closing costs

certificate of eligibility

**certificate of reasonable value
(CRV)**

direct endorsement program

Energy Efficient Mortgage (EEM)

entitlement

funding fee

**Home Equity Conversion Mortgage
(HECM)**

housing ratio

mortgage insurance premium (MIP)

partial entitlement

rehabilitation loan FHA 203(k)

release of liability

residual income

substitution of entitlement

total obligations ratio

The Federal Housing Administration (FHA) was established under the provisions of the National Housing Act of 1934. It was organized to stimulate new jobs by increasing activities in the construction industry; to stabilize the real estate mortgage market; and to facilitate the financing of repairs, additions, and sales of existing homes

and other properties. A system of mortgage loan insurance was developed to accomplish these goals. In this system, the credit of the U.S. government is placed squarely behind the credit of an individual borrower. The FHA has insured over 40 million home mortgages since it began in 1934.

It long has been the custom in the United States to acknowledge the needs of the men and women who serve in the armed forces. They and their dependents receive special consideration in terms of educational opportunities, medical care, and housing allowances. The Department of Veterans Affairs (VA) supervises a vast network of programs designed to aid U.S. war veterans.

In 1944, shortly before the end of World War II, Congress passed the Serviceman's Readjustment Act, more commonly known as the GI Bill of Rights. This program was designed to provide returning veterans medical benefits, bonuses, and low-interest loans to help them readjust more easily to civilian life. Title III of this act provides guarantees to lenders making real estate loans to eligible veterans that these loans will be repaid regardless of any borrower default. Special finance programs have been established to provide funds to eligible veterans, reservists, and members of the National Guard to enable them to purchase homes, farms, or ranches and to improve these properties.

FEDERAL HOUSING ADMINISTRATION (FHA)

The FHA operates entirely from its self-generated income through the proceeds of mortgage insurance premiums paid by borrowers. Although the variety of attractive conventional loan programs available over the past several years had lowered the FHA share of the mortgage market, it has once again become the loan of choice in response to the mortgage lending crisis. The FHA loan is a viable product for first-time homebuyers, borrowers with credit issues who may have trouble qualifying for a conventional loan, and for the purchase of manufactured housing.

Organization and Requirements

Since 1965, the FHA has operated under the direction of the Department of Housing and Urban Development (HUD) Office of Housing with headquarters in Washington, DC, and four regional centers located in Atlanta, Denver, Philadelphia, and Santa Ana. Through these offices, the FHA closely supervises the issuance of mortgage loans bearing its insurance.

Any lender participating in the FHA insurance program must grant long-term, self-amortizing loans at interest rates established in the marketplace. There is no limit on the number of points that may be paid by the borrower, although they must be reasonable. The FHA designates qualified lenders to underwrite loans directly without submitting applications to the FHA. These lenders participate in the **direct endorsement program**.

Every loan application is reviewed carefully to determine the borrower's financial credit and ability to make payments. In addition, a comprehensive written appraisal report is made on the condition and value of the property to be pledged as collateral for the loan. All property must meet certain minimum standards of acceptability. After qualifying the borrower and the property, the FHA issues a conditional commitment for mortgage insurance to the lender reflecting the value of the property. This commitment is valid for six months on existing property and for nine months on new construction.

Since September 1999, FHA requires appraisers evaluating property for FHA-insured loans to be state licensed or certified. In addition to providing an estimate of value, the appraisal provides an examination of the property for any visible, obvious, or apparent deficiencies. The appraisal must contain the statement, "FHD/FHA MAKES NO WARRANTIES AS TO THE VALUE AND/OR CONDITION OF ANY FHA-APPRAISED PROPERTY." The buyers are advised to have the house inspected by a professional home inspector. Every FHA borrower is required to receive a form entitled *For Your Protection: Get a Home Inspection*. A sample of this form is available at <http://portal.hud.gov/hudportal/documents/huddoc?id=92564-cn.pdf>.

As of 2010, all condominium developments must be re-approved for FHA financing every two years. Spot approvals for individual condo units no longer exist. The *Condominium Project Approval and Processing Guide* is available online at <http://portal.hud.gov/hudportal/documents/huddoc?id=12-18ml.pdf>. The guide was designed to provide guidance for approving condominium projects under Section 203(b) insurance.

In the past, it has often been difficult to obtain FHA financing for condominiums because of the limitations on the percentage of investor owners. In September 2012, FHA made the following temporary approval provisions to the *Condominium Project Approval and Processing Guide*:

- A developer or single investor may own up to 50% of the total units at the time of the project approval.
- Mixed-use developments are defined as developments with a combination of any of the following: commercial, residential, retail, office, or parking spaces.
- No more than 15% of the units can be in arrears.
- The Project Owner's Certification document has been revised.

For more details, see www.hud.gov.

FHA-INSURED LOAN PROGRAM

The FHA is designed as a program of mortgage insurance, so it does not make direct loans to borrowers, except in very special circumstances involving the resale of properties acquired by the FHA as a result of foreclosure. Even under these circumstances, the FHA usually requires a buyer of a foreclosed property to secure financing elsewhere and pay the FHA cash for the property. Although FHA lenders are required to make every effort to offset a possible foreclosure, in the event of a default and subsequent foreclosure, an

insured lender will look to the FHA to recover the unpaid balance of the mortgage and any costs involved in the foreclosure action.

By designing a program of mortgage insurance funded by mortgage insurance premiums (MIPs), the FHA has reduced the down payment obstacle for cash-short buyers. By insuring 100% of the loan amount, the insurance program eliminates lenders' risks and preserves their fiduciary profiles by ensuring that FHA lenders will not lose any money on loans they make to eligible borrowers. This FHA insurance helps stabilize the mortgage market and develops an active national secondary market for FHA mortgage loans.

Existing FHA Programs

The National Housing Act of 1934 provided for Title I and Title II insurance programs that are still in use today, along with additional sections that have been added to reflect consumer needs and market conditions. Changes to both Title I and Title II under the Housing and Economic Recovery Act of 2008 (HERA) are reflected in the following material.

Title I. Title I, Section 2 provides insurance for loans to finance light or moderate rehabilitation of properties, including the construction of nonresidential buildings. Loans on single-family homes may be used for alterations, repairs, and site improvements. Loans on multifamily structures may only be used for building alteration and repairs.

Maximum Loan Amount:

- Single-family house—\$25,000
- Manufactured house on permanent foundation—\$25,090
- Manufactured house (classified as personal property)—\$7,500
- Multifamily structure—average of \$12,000 per unit, up to \$60,000

Maximum Loan Term:

- Single-family house—20 years
- Manufactured house on permanent foundation—15 years
- Manufactured house (classified as personal property)—12 years
- Multifamily structure—20 years

The interest rate is based on the common market rate and is negotiable between lender and borrower. Any loan over \$7,500 must be secured by a mortgage or deed of trust on the property. There is no prepayment penalty. The structure must have been completed and occupied for at least 90 days.

Manufactured Home Financing. Since 1969, Title I, Section 2 provided insurance loans used for the purchase or refinancing of a manufactured home, a developed lot on which to place a manufactured home, or a combination of lot and home. Title I Manufactured Housing as created under HERA replaced the existing program effective April 1, 2009, with new insurance coverage, premiums, underwriting guidelines, and loan limits. Highlights of the program currently in place are included here.

Maximum loan amounts as of 2014 are as follows:

- Manufactured home only—\$69,678 20-year term
- Manufactured home lot—\$23,226 15-year term
- Manufactured home and lot—\$92,904 20-year term
- Multi-section manufactured home and lot 25-year term

The maximum loan limit for lot and combination loans may be as much as 85% higher in designated high-cost areas. Loan limits may be adjusted annually based on manufactured housing price data collected by the U.S. Census Bureau.

Manufactured homes must comply with the Model Manufactured Home Installation Standards and all applicable state and local requirements governing the installation and construction of the foundation system. The home must be installed on a suitable home site that meets local standards and has adequate water supply and sewage disposal facilities. The site may be a rental site in a manufactured home park meeting FHA guidelines or on an individual site owned or leased by the borrower. Built-in appliances, equipment, and carpeting may also be financed. Financing under Title I mortgage loans is provided by FHA-approved lenders. Credit is granted based on the borrower's credit history and ability to repay the loan in regular monthly installments. The up-front mortgage insurance premium may not exceed 2.25% with annual premiums of not more than 1% of the original insured obligation.

Title II. Title II originally established two basic mortgage insurance programs: Section 203 for one- to four-family homes and Section 207 for multifamily projects such as rental housing, manufactured home parks, and multifamily housing projects. Many additional programs have been added over the years. The most frequently used Title II insurance programs are described in more detail later in the chapter. Changes made under the Housing and Economic Recovery Act of 2008 (HERA) are reflected here:

- Section 203(b)—mortgage insurance for one- to four-family homes, including single units in a condominium project
- Section 203(h)—mortgage insurance for disaster victims (100% financing available; must file within one year after declaration of disaster)
- Section 203(k)—mortgage insurance for purchase plus rehabilitation
- Section 203(n)—mortgage insurance for purchase of a unit in a cooperative housing project
- Section 221(d)(3) and (4)—mortgage insurance for multifamily rental or cooperative projects
- Section 223(e)—mortgage insurance for older, declining areas
- Section 234(c)—mortgage insurance for condominium projects
- Section 251—mortgage insurance for adjustable-rate mortgages

- Section 255—mortgage insurance for Home Equity Conversion Mortgage (reverse mortgage)
- Section 811—supportive housing for persons with disabilities (provides direct funding to nonprofit organizations to support housing for low-income adults with disabilities)

Special HUD/FHA Programs

Special programs to assist buyers and homeowners are available through HUD/FHA, including the following.

Energy Efficient Mortgage (EEM). The EEM can be used to finance the cost of adding energy-efficient features to new or existing houses in conjunction with a Section 203(b) or 203(k) loan. It can also be used with the Section 203(h) program for victims of presidential-declared disasters. The cost of the energy-efficient improvements that are eligible for financing into the mortgage is the greater of 5% of the property's value or 115% of the median sales price for the area, or 150% of the conforming Freddie Mac loan limit. The money for the improvements is placed in an escrow account at closing and released after an inspection verifying that the improvements are installed and that energy savings will be achieved. The total loan amount can exceed the FHA loan limit by the amount of the energy-efficient improvements.

Home Equity Conversion Mortgage (HECM). FHA's mortgage insurance makes HUD's **Home Equity Conversion Mortgage (HECM)** reverse mortgage program less expensive and more attractive for homeowners 62 and older who wish to borrow against the equity in their homes. No monthly payments are required, and there are no asset or income requirements or limitations. Homeowners may receive a percentage of the value of the home's equity in a lump sum, on a monthly basis (either for life or for a fixed term), or as a line-of-credit. No repayment of the loan plus interest and other fees is due until the surviving homeowner leaves the home. The FHA insurance provides the assurance that the funds will continue as long as one surviving member remains in the home and that in the event that the eventual sale does not cover the balance due the lender, there will be no debt carried over to the estate or heirs.

New provisions added under HERA include the following:

- Seniors can purchase and obtain a HECM loan in a single transaction as long as the home is to be a primary residence.
- All applicants for a HECM loan must receive counseling by trained and tested counselors who follow uniform protocols. The FHA uses a portion of the mortgage insurance premiums to fund such counseling.
- Lenders are prohibited from requiring the borrower to purchase insurance, an annuity, or other additional product as a requirement or condition of eligibility for a HECM loan (exceptions are title insurance, hazard, flood, or other peril insurance).
- HECM origination fees are limited to 2% of maximum claim amount (MCA), up to \$200,000 and 1% of MCA over \$200,000. (For homes valued less than \$125,000, the fee is limited to \$2,500.)

- Cooperatives may now be insured under HECM program (condominiums were already allowed).
- The single loan limit of \$417,000 applies nationwide, up to \$625,500 in high-cost areas.
- The annual mortgage insurance premium for all HECM loans is 1.25%. An initial MIP ranging from 0.5% to 2.5% may be charged depending on the type of disbursements.

Good Neighbor Next Door. The Officer Next Door program has been expanded to include law enforcement officers, pre-kindergarten through 12th grade teachers, firefighters, and emergency medical technicians. Under this program, HUD offers a discount of 50% from the list price of the home with a down payment of \$100. The borrower must commit to live in the property for at least 36 months. Available homes are listed by state on the internet. If more than one person makes an offer on a property, selection is made by a random lottery. If the property needs repairs, a 203(k) mortgage may be used.

Homeownership Vouchers. The Housing Choice Voucher program, formerly known as Section 8, has expanded its rental assistance program to allow participants to use Homeownership Voucher funds to assist in meeting monthly homeownership expenses such as mortgage payments, real estate taxes and insurance premiums, utilities, maintenance costs, and repairs. Applicants must be first-time homeowners, have at least one member of the family employed, and meet minimum income requirements. Interested applicants should contact their local Public Housing Authority for more information.

Native American Housing. Under Section 184 Indian Housing Loan Guarantee Program, HUD offers homeownership and housing rehabilitation opportunities for American Indian and Alaska Native families and tribes. FHA will also insure mortgage loans for Native Americans under the Section 248 program for properties on tribal lands.

Title II Manufactured Home Financing. If a higher loan amount than is provided under Title I is required, the FHA does offer financing for manufactured homes under Title II. The mortgage must cover both the manufactured home and its site with a term on not more than three years. There are some additional requirements, including the following:

- Have a floor area of not less than 400 square feet
- Be constructed after June 15, 1976
- Be classified as real estate
- Be built and remain on a permanent chassis
- Have a finished grade elevation at or above the 100-year elevation

Disaster Relief. In November 2013, FHA issued the following guidance for FHA borrowers struggling to repair or rebuild after disasters (such as Hurricane Sandy):

- There is a 90-day moratorium on foreclosures.
- Servicers must consider a full range of benefits, such as mortgage modifications, partial claims, FHA-HAMP or other refinance options, and a waiver of late charges.
- Lenders are to release homeowner insurance proceeds to the borrower.

Refer to HUD Section 203(h) and 203(k) for further information.

Underwriting Guidelines

Like Fannie Mae and Freddie Mac, the FHA has its own set of guidelines to qualify eligible borrowers for acceptable loans. These requirements include all of the following elements.

Maximum Loan Limitations. As part of the **Housing and Economic Recovery Act of 2008**, the FHA established a set formula for mortgage loan limits. FHA loan limits were to be set at 115% of the median house price in a given area but could not be lower than 65% of the conforming loan limit. In November 2011, Congress raised the loan limit for FHA high-cost areas to \$729,750, while leaving the limit for Fannie Mae and Freddie Mac at \$625,500. However, in 2014 the loan limit for high-cost areas was adjusted back to the original 2008 amount of \$625,500.

FHA loan limits for 2014 are shown in Figure 8.1.

The maximum loan amounts for a geographical area may be found at <https://entp.hud.gov/idapp/html/hicostlook.cfm>.

Down Payment Requirements. The FHA has greatly simplified its formula for calculating the down payment required on its insured loans. As of January 1, 2009, the purchaser must provide 3.5% of either the sales price or appraised value (whichever is less) from their own funds; a family gift; or a grant from a local, state, or nonprofit down payment assistance program that does not receive any financial benefit from the transaction. In most cases, this is applied as the down payment. For some special programs that allow for a higher loan-to-value (LTV) ratio, a part of the 3.5% may go towards approved closing costs.

FIGURE 8.1 CY2014 FHA Maximum Loan Limits

<i>Type of Property</i>	<i>Standard</i>	<i>High-Cost Areas</i>
Single-Family	\$271,050	\$625,500
Duplex	\$347,000	\$800,715
Triplex	\$419,425	\$967,950
Four Units	\$521,250	\$1,202,925

(All limits are 150% higher in Alaska, Guam, Hawaii, and the U.S. Virgin Islands.)

Borrowers' Income Qualifications. The FHA qualifies borrowers based on two ratios (the borrowers must qualify under both ratios):

- The **housing ratio** of 31% is one way borrower qualifications are tested. A borrower's total monthly housing expenses may not exceed 31% of the total gross monthly income. Included in these expenses are mortgage, principal, and interest; property taxes; home insurance premiums; mortgage insurance premiums; and homeowners' or condominium association fees if applicable.

The housing ratio may be raised if the borrowers have certain compensating factors, such as

- low long-term debt,
 - a large down payment,
 - minimal credit use,
 - excellent job history,
 - excellent payment history for amounts equal to or higher than new loan payment, or
 - additional income potential.
- The **total obligations ratio** of 43% is the other measure the FHA uses to gauge borrower qualifications. A borrower's total monthly obligations may not exceed 43% of the total monthly gross income. Included in these obligations are monthly housing expenses plus monthly debt payments. Debts that will be paid in full within ten months are sometimes not included. Alimony and child support payments are deducted from monthly gross income before calculating the qualifying ratio.

■ **FOR EXAMPLE** Assume that borrowers want to qualify for a \$200,000 FHA-insured home loan at 6% interest for 30 years. The up-front MIP of 1.75% is added to the loan amount. The principal and interest plus MIP payment is \$1,220 per month, property taxes are \$300 per month, hazard insurance premium is \$30 per month, and the monthly MIP payment is \$220.46 ($\$203,500 \times 1.30\% = \$2,645.50 \div 12 = \$220.46$). The borrowers pay \$600 per month on other long-term debt. (All numbers are rounded off.)

\$1,220	Principal and interest + Up-front MIP ($\$200,000 + \$3,500 = \$203,500 @ 6\%$)
300	Property taxes
30	Hazard insurance
<u>220</u>	Monthly MIP
\$1,770	Housing cost $\div 0.31 = \$5,710$
+ 600	Other debts
\$2,370	Total obligations $\div 0.43 = \$5,512$

To qualify for this loan, the borrowers would need to earn at least \$5,710 in combined gross monthly income (\$68,520 annually). The required gross monthly income must meet the requirements of the housing ratio unless the total of other debts makes the required amount even higher.

Non-Traditional Credit and Credit Scoring. In some cases, the FHA may allow a lender to develop a non-traditional mortgage credit report (NTMCR) to document a borrower's payment history in cases where a credit bureau score cannot be derived. A 12-month history of timely payments for rent, utilities, telephone and cellular phone services, and cable television is preferred. Additional sources that may be given consideration include insurance coverage (medical, auto, or life insurance), childcare payments, and other documented history of payments or savings.

Borrowers with a credit score of 500 or less are not eligible for an FHA loan. Generally, a score of 620 is preferred.

Mortgage Insurance Premium (MIP). When the FHA issues an insurance commitment to a lender, it promises to repay the balance of the loan in full if the borrower defaults. This guaranty is funded by imposing a **mortgage insurance premium (MIP)** that must be paid by the borrower when obtaining an FHA-insured loan. It can be paid in cash or financed even if the loan plus the MIP exceeds the maximum loan limit.

As of February 2012, the up-front MIP premium of 1.75% of the loan amount is charged on all FHA loans, including those for condominiums.

FHA borrowers must also pay an annual premium, which is payable monthly and is included in the regular PITI payment. This MIP applies to all types of FHA loans.

As of June 2013, the annual premium is as follows:

- LTV less than 95% 30-year loan 1.30%
- LTV greater than 95.01% 30-year loan 1.35%
- LTV less than 78% 15-year loan 0.45%
- LTV 78.01% to 90% 15-year loan 0.45%
- LTV greater than 90.01% 15-year loan 0.70%

FHA monthly insurance payments will no longer be automatically terminated when an LTV of 78% is reached. MIP will only be canceled under the following conditions:

- For mortgage terms of more than 15 years with an original LTV of less than 90%, the annual MIP will be canceled when the loan-to-value ratio reaches 78%, provided the mortgagor has paid the annual premium for at least 11 years.
- For mortgage terms of 15 years or less and with original loan-to-value ratios of 90% or less, annual premiums will be canceled when the loan-to-value ratio reaches 78%, provided payments have been made for at least 11 years.

In Practice

A loan officer is working with a married couple who have a combined monthly gross income of \$4,000. They have \$5,000 in savings and monthly debts of \$600. They have found a 20-year-old, three-bedroom house with a large yard in an older neighborhood just 15 miles from downtown where they both work. They love the house, but the sales price of \$150,000 seems to be out of their range. The loan officer has suggested they look into an FHA loan. The loan

officer is meeting with the couple today to go over the FHA guidelines. The loan officer tells them that he has 5.5% financing for a 30-year loan with no points. Factors that will be taken into consideration include the following:

- **Maximum loan amount:** The maximum loan amount for their geographic area is \$160,000. With a \$5,250 down payment, they will only need to borrow \$144,750 so they fit within the maximum loan amount limits.
- **Down payment:** Purchasers must provide 3.5% of the sales price for a down payment of \$5,250. The couple is confident they can add \$250 to their present savings of \$5,000, which will cover the down payment. Because they do not have additional funds for closing costs, they will ask the seller to contribute the 6% of the sales price allowed by the FHA to be used for their closing costs.
- **Qualifying ratios:** The FHA allows 31% of gross monthly income for housing and 43% for total debt obligation. Their combined monthly gross income of \$4,000 \times 31% = \$1,240; \$4,000 \times 43% = \$1,720.

Deducting the \$600 monthly debt from the \$1,720 allowed for total debt leaves \$1,120 for PITI (principal, interest, taxes, and insurance). Subtracting 30% for taxes, homeowners insurance, and mortgage insurance leaves \$784 (\$1,120 – \$360). The dollars available for PITI must be divided by the rate factor for a 5.5% loan: $\$784 \div \5.68 (rate factor for 5.5%) = \$138,000 able to be borrowed. Because they need to borrow \$144,750, they would not qualify to buy the house. If they could reduce the monthly debt obligation from \$600 to \$400, they would stay within the guidelines and be able to use the \$1,240 (31% of GMI) for PITI (\$1,720 – 400 = \$1,320). $\$1,240 - 30\% (372) = \868 for PI. $\$868 \div 5.68 = \$152,820$ able to be borrowed. The final calculations for the couple's house are as follows:

Sales price	\$150,000
Down payment	<u>– 5,250</u>
Loan amount	144,750
Plus 1.75% up-front MIP (\$2,533)	\$2,533
	\$147,283

Monthly PI	\$ 836.26
Taxes and insurance	230.00
Annual MIP (1.30%)	<u>160.46</u>
Total PITI payment	\$1,226.72

$\$1,226.72 \div 4,000 = 31\%$ (qualifies under FHA ratio of 31%)

Plus long-term debt	400.00
	\$1,626.72

$\$1,626.72 \div 4,000 = 41\%$ (qualifies under FHA ratio of 43%)

Allowable Closing Costs. The FHA has strict guidelines defining **allowable closing costs** that may be charged to a borrower. The amounts may differ by geographic area but

must be considered to be reasonable and customary. All other costs in the transaction are generally paid by the seller when purchasing a new home or by the lender in the case of a refinance.

The seller may contribute for the borrower up to 6% of the sales price to cover discount points and other allowable closing costs.

The allowable closing costs are

- appraisal fee and any inspection fees;
- actual costs of credit reports;
- lender's origination fee;
- deposit verification fee;
- home inspection service fees up to \$200;
- cost of title examination and title insurance;
- document preparation (by a third party not controlled by the lender);
- property survey;
- attorney's fees;
- recording fees, transfer stamps, and taxes; and
- test and certification fees, water tests, and so on.

The allowable costs in a refinance are

- courier fees,
- wire transfer fees,
- fees to pay off bills, and
- reconveyance fees.

Second Mortgages/Buydowns. In some cases, the FHA will allow a second mortgage to be acquired on the collateral property. There are certain conditions, however, including the following:

- The total of the first and second mortgages must not exceed the allowable maximum LTV ratio.
- The borrower must qualify to make both payments.
- There can be no balloon payment on the second mortgage if it matures before five years.
- The payments on the second mortgage must not vary to any large degree.
- The second mortgage must not contain a prepayment penalty.

The FHA allows mortgage buydowns when the borrower or seller can make an advance cash payment to lower the interest rate for a period of time. This effectively reduces the corresponding monthly payments. The FHA also allows the borrower the advantage to qualify for the loan at the bought-down interest rate, not the contract interest rate.

Assumptions. FHA loans originated prior to December 1989 are generally assumable without qualifying, but the original borrower retains some responsibility in the event of a default. For FHA loans originated after December 1989, all sellers are released from liability under an assumption. Buyers have to qualify under the current 31% and 43% rule and must occupy the property. The FHA currently prohibits the assumption of loans by investors.

FHA TOTAL Scorecard. The FHA TOTAL Scorecard was developed by HUD to evaluate the credit risk for loans that are submitted to an automated underwriting system (AUS). The Scoreboard recommends levels of underwriting and documentation to determine a loan's eligibility for FHA insurance. There are two risk classifications: "Accept/Approve" or "Refer." An "Accept/Approve" indicates that the FHA will ensure the loan with reduced documentation; "Refer" means the lender must manually underwrite the loan.

FHA-HAMP Guidelines. FHA's Loss Mitigation Program was established in 1996 to ensure that distressed FHA mortgagors were given an opportunity to retain their homes and minimize losses to the FHA Mutual Mortgage Insurance Fund. Changes were made to the FHA version of HAMP in 2012 to

- eliminate the requirement for a back-end debt-to-income ratio of 55%,
- eliminate the requirement that the mortgage be no more than 12 months past due, and
- permit only one loan modification in 24 months.

Most Frequently Used FHA Loans

Section 203(b): One-Family to Four-Family Mortgage Insurance. This mainstay of the FHA single-family insurance programs remains an important financing option for first-time homebuyers, persons who may have trouble qualifying for a conventional loan, or those living in underserved areas. The low down payment, higher total debt ratio, and consideration of compensating factors may make it possible for owner-occupants to achieve their dream of homeownership. FHA 203(b) loans can also be used for the purchase of condominium and cooperative units.

Section 203(k): Rehabilitation Mortgage Insurance. The Section 203(k) loan makes it possible for the purchaser to obtain a single long-term loan (either fixed or adjustable rate) to cover both the acquisition and rehabilitation of a property. The 203(k) is also available for refinancing a property that is at least one year old. The value of the property is limited by the FHA mortgage loan limits for the area and is determined by either the value before rehabilitation plus the cost of rehabilitation or 110% of the appraised value after rehabilitation, whichever is less.

Other features of the **rehabilitation loan FHA 203(k)** include the following:

- Rehab costs must be at least \$5,000.
- The borrower pays only taxes and insurance during the first six months.
- The rehab funds are paid to the borrower in draws.
- The rehab costs and installation time must be approved by the lender before the loan can be granted.
- Basic energy efficiency and structural standards must be met.

The FHA 203(k) program is not available to investors. A list of the types of improvements that may be made under 203(k) financing and other information regarding eligible properties and applicants may be found on the HUD website at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/203k.

The Streamlined 203(k) Limited Repair Program permits homebuyers to finance up to an additional \$35,000 into their mortgages to improve or upgrade their homes before move-in. The cash can be used to pay for property repairs or improvements identified by a home inspector or FHA appraiser.

Section 251: Insurance for Adjustable-Rate Mortgage. The FHA adjustable-rates mortgages (ARMs) are available to owner-occupants of one- to four-family dwelling units. The down payment, maximum loan amount, and qualifying standards are the same as for 203(b) and may be written for 30 years. The FHA offers a standard one-year ARM and four hybrid ARM products with an initial interest rate that is constant for the first three, five, seven, or ten years. After the initial period, the interest rate will adjust annually. FHA ARMs have both annual and life-of-the-loan caps on the amount that the interest rate can go either up or down at each adjustment period.

The different interest rate caps are as follows:

- One- and three-year ARMs have annual caps of 1% and life-of-loan caps of 5%.
- Five-, seven-, and ten-year hybrid ARMs have annual caps of 2% and life-of-loan caps of 6%.

The FHA ARMs are fully assumable, and buydowns are permitted. When qualifying at the buydown rate of interest, it is possible for the borrower to afford a larger loan amount. When interest rates are low, a fixed-rate loan may be preferable to an ARM, especially when the up-front and monthly mortgage insurance premiums are factored in.

Streamline Refinance. Since 1980, FHA has permitted insured mortgages to be streamline refinanced. The amount of documentation and underwriting is greatly reduced, although closing costs still apply. These costs can be included in the new mortgage amount with sufficient equity in the property as determined by an appraisal. The basic requirements for a streamline refinance are

- the mortgage must already be FHA insured;
- the mortgage must be current, not delinquent;

- the refinance must result in lowering of monthly principal and interest payment; and
- no cash may be taken out.

Direct Endorsement

Under the **direct endorsement program**, applications for the FHA's single-family mortgage insurance programs can be underwritten by an approved lender that certifies the mortgage complies with applicable FHA requirements. The lender performs all appraisal duties and analyzes the borrower's credit. Direct endorsement leaves FHA with the risk of loss from default but gives it control through its ability to remove the lender from the program. The majority of all FHA mortgage insurance applications are now being processed under its format.

FHA CONTRIBUTIONS TO REAL ESTATE FINANCE

Every financier recognizes the significance of the FHA's major contributions to the stabilization of the real estate mortgage market. These contributions are summarized in the following:

- *The FHA instituted basic standards for qualifying borrowers.* Because credit applications and borrower creditability criteria are standardized, all lenders who issue FHA-insured loans use the same basic language and tools.
- *The FHA instituted standards for appraising property.* Minimum construction standards are established that must be met before a property can qualify for an FHA-insured loan. These standards apply to both new and used buildings, and they are measured by an FHA appraisal of the potential collateral.
- *The long-term amortized loan was used.* Prior to the FHA's long-term amortization design, in which a borrower has from 15 to 30 years to repay a loan in equal monthly payments, most mortgage loans had to be *paid in full* or *refinanced* approximately every five years. This created hardships for both borrowers and sellers and contributed to the many foreclosures during the depression years. Currently, the FHA monthly payments include an amount for principal, interest, property taxes, homeowners insurance, and, if required, property improvement assessments and FHA mortgage insurance premiums.
- *The FHA lending standards and amortization design provided the foundation for a national market in mortgage securities.* By developing reliability and safety in mortgage loan investments, the FHA enables financial investors from all over the world to trade in these securities.

VA LOAN GUARANTEE PROGRAM

Originally, the amount of guarantee was for 50% of the loan's balance, not to exceed \$2,000. In 1945, Congress increased the guarantee to 60% against \$4,000 and has gradually increased these limits. The conforming loan limit is adjusted each year by the Federal Housing Finance Agency (FHFA). In 2012, the VA guarantee is \$104,250, or 25% of the current Freddie Mac loan limit of \$417,000 (see Figure 8.2)

Because the lender regards this guaranteed amount the same as a 25% down payment, the lender will loan four times the guaranty for a single-family home. A lender would be willing to loan a qualified veteran borrower up to \$417,000. The maximum loan amount would be 50% higher for first mortgages in Alaska, Hawaii, Guam, and the U.S. Virgin Islands.

The maximum loan may also be higher in certain high-cost areas. A county-by-county list for 2014 can be viewed at www.benefits.va.gov.

Program Application

In general, the VA is concerned with guaranteeing loans made by institutional lenders, such as commercial banks, thrift organizations, life insurance companies, and mortgage bankers and brokers. It tries to eliminate any risks taken by these lenders when they make loans on real estate to eligible veterans. If a veteran cannot continue to meet the required payments, the lender is compensated by the VA for any losses incurred in the foreclosure and subsequent sale of the property, up to the limit of the guarantee. The operations of the VA real estate loan guarantee program are managed by nine regional centers located throughout the country. The program is not designed to be used indiscriminately. Each loan application is reviewed carefully to determine the veteran's eligibility, credit history, and ability to pay. The value of the property is firmly established by an appraisal, and assurances are secured that the veteran will occupy the premises as the major residence. Poor risks are denied loans and are referred to other programs. The VA guarantees close to 200,000 loans per year.

Several veterans, related or not, may purchase one-family to four-family homes as partners, as long as they intend to occupy the property. A veteran and a nonveteran who are not married may purchase a home together as co-borrowers, although the VA will not guarantee the nonveteran's portion of the loan. However, the VA does qualify common-law marriages without reduction of the loan guarantee for the nonveteran, as long as proper documentation has been supplied.

The VA guarantees mortgage loans for single-family homes, condominiums, cooperative units, manufactured housing, and farm homes.

FIGURE 8.2 VA Loan Guarantee Periods

December 28, 1945	\$ 4,000
July 12, 1950	7,500
May 7, 1968	12,500
December 31, 1974	17,500
October 1, 1978	25,000
March 1, 1988	36,000
December 20, 1989	46,000
October 13, 1995	50,750
January 1, 2005	89,912
January 1, 2006, to present	104,250

Eligibility/Entitlement

A veteran's eligibility or **entitlement** to participate in the program is derived from the following active-duty criteria:

- More than 90 days of continuous active duty, discharge because of a service-connected disability, or separation under other-than-dishonorable conditions during any of the following wartime periods:

World War II	September 16, 1940, to July 25, 1947
Korean Conflict	June 27, 1950, to January 31, 1955
Vietnam War	August 5, 1964, to May 7, 1975
Persian Gulf War	August 2, 1990, to undetermined date

- More than 181 days of continuous active duty for other than training purposes, discharge because of a service-connected disability, or separation under other-than-dishonorable conditions during the following peacetime periods:

Post-World War II	July 26, 1947, to June 26, 1950
Post-Korean Conflict	February 1, 1955, to August 4, 1964
Post-Vietnam War	May 8, 1975, to September 7, 1980 (enlisted) May 8, 1975, to October 16, 1981 (officer)

- For enlisted personnel, two years of continuous active duty or separation under other-than-dishonorable conditions during the peacetime period from 1980 to the present. For officers, two years of continuous active duty or separation under other-than-dishonorable discharge during the peacetime period from 1981 to the present.
- At least six years of continuous active duty as a reservist in the Army, Navy, Air Force, Marine Corps, Coast Guard, or National Guard. Active duty service personnel are eligible after serving 181 days of continuous activity (90 days during the Gulf War).

Unremarried spouses of veterans may be eligible for VA loans if the veteran died of a service-connected injury or illness or is listed as missing in action.

Certificate of Eligibility

One of the most important documents needed for a loan application by a veteran is a **certificate of eligibility**. To receive this certificate, the veteran must secure forms to determine eligibility as well as an 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.

There is no time limit on the entitlement, and it remains in effect until completely used up. This loan guarantee must be used in the United States, its territories, and its protectorates. A certificate may be requested on VA Form 26-1880 and submitted along with the DD Form 214 (Certificate of Release or Discharge) through the local VA office. It can also be ordered online at www.ebenefits.va.gov or through a local lender. After using the VA guarantee for a real estate loan, the veteran may gain the restoration of eligibility when the loan is paid in full and the property has been conveyed to another owner (there is a one-time exemption of the conveyance requirement).

Partial Entitlement

Veterans who have used their benefits in the past may be eligible for another VA loan if they have any remaining entitlement. With a **partial entitlement**, a veteran may pay cash down to the maximum loan amount and still benefit accordingly.

To determine any remaining entitlement, examine Figure 8.2 and subtract the amount used previously from the amount currently in effect. This is the amount available for the guarantee. Finally, to determine the maximum VA loan allowed under a partial entitlement, take 75% of the appraised value and add the remaining entitlement amount.

■ **FOR EXAMPLE** Consider a veteran who purchased a house in 1989 using the entitlement of \$46,000. In 1999, the veteran decided to purchase a new house but wanted to keep the original residence for an income property. With the new house appraised for \$150,000, a new VA loan of \$117,250 was acquired using the following process:

Maximum 1999 entitlement	\$ 50,750
1989 entitlement	<u>− 46,000</u>
Remaining entitlement	4,750
75% of \$150,000	<u>+112,500</u>
	\$117,250

To complete the transaction, the veteran paid \$32,750 as a cash down payment.

Certificate of Reasonable Value (CRV)

The VA requires a VA-assigned certified real estate appraiser to submit a formal estimate of the value of the property to be financed. The appraiser issues a **certificate of reasonable value (CRV)**, stating the amount of the appraisal. This CRV is valid for 6 months for existing properties and 12 months for new construction. It may not be extended.

If a sale is made subject to a CRV and the appraisal comes in at less than the sale price, the following may occur:

- The buyer can make up the difference in cash.
- The seller can accept the lower amount as the sale price.
- The buyer and seller can compromise.
- The transaction can be canceled.

In the purchase of a home in excess of the maximum guaranteed VA loan amount with no money down, the difference is required to be paid in cash. The VA reserves the right to approve the source of the cash. This is to ensure that the veteran is not borrowing an additional amount that would adversely affect the total debt ratio.

Interest

In the past, the VA specified the interest rate the lender could charge the veteran. Now, however, the VA allows the borrower the opportunity to shop the marketplace and negotiate the best rate available. Thus, all types of mortgage loans are competitive as to interest rates, leveling the financing market.

Qualifying Requirements

The VA uses only one ratio to analyze a borrower's ability to qualify for the loan payment. This ratio is 41% of the borrower's gross monthly income and includes principal, interest, taxes, insurance, utilities, maintenance, repairs, and other monthly obligations. The VA provides maintenance and utilities guidelines for all states using the following formula:

$$\text{Square feet of living area} \times \$0.14 \text{ per square foot}$$

For example, $1,500 \text{ sq. ft.} \times 0.14 = \210 per month. The VA also provides the lender with a table of required **residual income** amounts based on geographic region and family size. Staying within the residual income guidelines is more important than meeting the 41% ratio.

The following is an example of the calculation of residual income (maintenance and utility costs are not used in this calculation):

Total monthly income:	\$2,500
	× 41%
41% of income	\$1,025
Less housing costs (PITI)	(800)
Less recurring debts	<u>(200)</u>
Total residual income	\$25

Like the FHA, the VA will sometimes allow for compensating factors such as

- excellent credit history,
- conservative use of consumer credit,

- minimal consumer debt,
- long-term employment,
- significant liquid assets,
- sizable down payment,
- existence of equity in refinancing loans,
- little or no increase in shelter expense,
- high residual income,
- low debt-to-income ratio,
- tax credits for child care, and
- tax benefits of home ownership.

Under no circumstances will compensating factors offset unsatisfactory credit.

■ **FOR EXAMPLE** A veteran applies for a VA loan of \$100,000 at 5% interest for 30 years. The monthly principal and interest payment is \$537. Other monthly costs include \$70 for taxes, \$25 for insurance, \$214 for maintenance and utilities, and \$200 for other obligations. The veteran's total gross monthly income will have to be at least \$2,673 (\$32,078 annually) to qualify for this loan.

Principal and Interest	\$ 537
Property Taxes	70
Homeowner Insurance	25
Maintenance and Utilities	214
Other Payments	<u>200</u>
Total Obligations	\$ 1,096
VA Income Ratio	<u>÷ 0.41</u>
Gross Monthly Income Required	\$ 2,673
	<u>× 12</u>
Gross Annual Income Required	\$ 32,078

Closing Costs

Closing costs may not be included in VA loans and must be paid in cash at closing. The only costs that may be charged to the veteran include the following:

- 1% of the loan amount charged by lender as loan origination fee
- Discount points as determined by market
- VA funding fee
- Reasonable and customary charges for appraisal, credit report, recording fees and/or taxes, taxes and/or assessments chargeable to borrower, initial deposit for tax and insurance escrow account, hazard insurance including flood insurance, survey if required, title examination, and title insurance

The seller may pay all of the borrower's closing costs plus an additional 4% of the loan amount to be used for the funding fee or to pay off borrower's debt to allow borrower to qualify for the loan.

Funding Fee

Although the VA does not charge a mortgage insurance premium, it does charge a **funding fee**, which may be used to cover expenses in case of borrower default. The funding fee may be paid in cash or included in the loan amount, even in excess of the CRV. However, the addition of the funding fee to the original loan amount may not exceed the maximum allowable loan. The funding fee is required on all VA loans except from veterans receiving compensation for service-connected disabilities, from veterans receiving retirement pay in lieu of disability compensation, from spouses of veterans who died in service or died from service-connected disabilities, and in some transactions in which a large down payment is made (see Figure 8.3).

■ **FOR EXAMPLE** The funding fee charged on a \$100,000 VA loan where the veteran makes no down payment is \$2,150:

$$\begin{array}{r} \$100,000 \\ \times 0.0215 \\ \hline \$ 2,150 \end{array}$$

■ **FOR EXAMPLE** The funding fee charged on a \$100,000 VA loan where the veteran makes a 10% down payment is \$1,250:

$$\begin{array}{r} \$100,000 \\ \times 0.0125 \\ \hline \$ 1,250 \end{array}$$

■ **FOR EXAMPLE** The funding fee charged on a \$100,000 VA loan secured for refinancing is \$500:

$$\begin{array}{r} \$100,000 \\ \times 0.005 \\ \hline \$ 500 \end{array}$$

Second Mortgages

The VA will allow second mortgages to be placed on the collateral property under the following conditions:

- The second mortgage document must be approved by the VA legal department prior to loan closing.
- The total of the first and second mortgage liens may not exceed the value of the property.
- The interest rate on the second mortgage may not exceed the interest rate on the first.

FIGURE 8.3 Schedule of Funding Fees for VA Loans

Down Payment	First-Time Use	Subsequent Use	Reservist/ National Guard	Subsequent Use (Reservist/ National Guard)
None	2.15%	3.30%	2.40%	3.30%
5% up to 10%	1.50%	1.50%	1.75%	1.75%
10% or more	1.25%	1.25%	1.50%	1.50%
Cash-out refinance	2.15%	3.30%	2.40%	3.30%

First Time or Subsequent—All Categories of Service	
Assumptions	0.50%
Rate reduction refinancing	0.50%
Manufactured home	1.00%

- The second mortgage may not have a prepayment penalty or a balloon payment.
- The second mortgage must be amortized for at least five years.

Buydowns

Buydowns are allowed only on VA loans issued with level payments. A buydown is an amount of money paid in advance, accepted by the lender, to reduce the interest rate on the loan. The buydown fee may be paid by the seller, the buyer, or family members. The borrower must qualify at the first year's payment rate.

Assumptions

Prior to March 1988, VA loans were fully assumable without prior lender approval of the buyer's credit. For VA loans made after this date, the buyer's credit must be approved by the lender prior to the assumption of an existing loan. Any unauthorized assumption may trigger a technical default, and the loan balance can be called in full. In any approved assumption, the loan interest rate will not be changed.

In Practice

Sally Green's real estate office is located very close to a military base, and she is currently working with four clients who are all interested in obtaining VA loans to purchase new houses. Sally is trying to determine their eligibility status. Mark Brown served for one year between March 1985 and March 1986 and has been told that only 180 days are required. Sam Jones served for 90 days during the Persian Gulf War. Michael Green served for eight years in the National Guard. John Smith used his VA eligibility in 1989.

Sally finds that Mark will not be eligible because two years of active service are required after 1980 (except for the Gulf War period). Sam and Michael should have full eligibility.

John Smith may have a partial entitlement. The entitlement in 1978 was \$25,000. As of January 2005, the entitlement is \$89,912, which would leave him with a \$64,912 partial entitlement. The banks will generally lend four times that amount for a no-money-down loan. If John wants to purchase a house costing \$250,000 the bank will lend 75% of the appraised value, plus the partial entitlement ($\$250,000 \times 75\% + \$64,912 = \$252,412$). John will not be required to make a down payment.

John may be pleasantly surprised to find that he has his full entitlement back. By checking with his regional VA office, he finds that the house that he purchased in 1978 and sold in 1984, letting the purchaser assume his loan, has been subsequently sold with all new conventional financing. John will have regained his entitlement at the current amount of \$104,250. He can now obtain a VA loan for up to \$417,000, as long as he meets all qualifying standards. He will have to pay a 3.3% funding fee this time, unless he is receiving disability payments from the VA.

Release of Liability/Novation

The original makers of a VA loan remain liable until it is paid in full or the veteran receives a **release of liability** or a **substitution of entitlement** from a cooperating buyer. The release of liability relieves the veteran-seller of the responsibility for repayment and any deficiencies resulting from a default on the loan.

Although it is unusual for a veteran to have more than one VA loan in effect at any one time, it is not unusual for a veteran to secure a complete release from the liability of a previous VA loan and a restoration of eligibility for a new maximum guarantee. General requirements for restoration of entitlement by the VA call for the veteran to sell the property and repay the debt in full. The VA does allow for a one-time-only provision for restoration of entitlement with repayment of the debt without having to dispose of the property. In addition, a veteran can qualify to ask the VA for a substitution of entitlement if the home is sold to another qualified veteran willing to assume the loan.

In cases in which a veteran's loan is assumed by a purchaser who is not a veteran, the VA will not allow the seller-veteran to regain maximum entitlement. The purchaser, however, can agree to assume the veteran's liability to reimburse the VA in case of default, and the buyer and seller can then petition the VA to release the veteran from all obligations. This full substitution technique is called novation. If the new buyers meet the credit requirements of the old lender, the VA may accept them in lieu of the veteran and release the veteran's liability on the loan. Note, however, that release of a veteran's liability does not restore eligibility for the maximum guarantee amount. It will not be restored until the loan is finally paid off by the purchaser.

ADDITIONAL VA LOAN PROGRAMS

Adjustable-Rate Mortgage

The Veteran's Benefits Act of 2008 extended the VA Adjustable-Rate Mortgage (ARM) program through September 30, 2012, and then in August of that year it was made a permanent loan product. Following are the key features of this program:

- Annually adjusted interest rate
- Interest rate adjustments limited to increase or decrease 1% per year
- Interest rate adjustments cannot exceed 5 percentage points over life of the loan
- ARM loan must be underwritten at 1% above initial rate

Refinancing

Three types of refinance programs are available to veterans:

- *VA Streamline Refinance.* Refinance for a lower interest rate with no out-of-pocket closing costs, no appraisal required, and no income or credit check needed. There is a 0.50% funding fee. (This is also referred to as the IRRRL program.)
- *Cash Out Refinance.* Refinance using existing equity to take out cash or pay off debts up to 90% of the value of the property. A funding fee is required.
- *Conventional to VA Mortgage.* Refinance up to 100% of the value of the property into a VA mortgage from a conventional loan with a maximum loan of \$417,000. A funding fee is required but may be financed. No private mortgage insurance is required, there are no out-of-pocket closing costs, and the new interest rate may be lower.

Special Programs

- *Section 184 for Indian Housing.* Loan product designed to meet needs of Native Americans on tribal lands.
- *Energy Efficient Mortgage (EEM).* Allows up to \$6,000 to be added to mortgage for energy-efficient improvements to the home.
- *Assistance to Veterans in Default.* The VA provides supplemental servicing assistance to help cure the default.

SUMMARY

The Federal Housing Administration (FHA) was established under the provisions of the National Housing Act of 1934 and is under the jurisdiction of the Department of Housing and Urban Development (HUD). Under FHA insurance, borrowers enjoy low down payments, a variety of loan arrangements, no due-on-sale clauses, fully assumable loans, and no prepayment penalties. Up-front insurance premiums are required.

The FHA collects monthly payments for annual renewal premiums on all newly issued loans. These premiums constitute the reserves from which the FHA pays the lenders for defaulted loans. As of April 2011, HUD is allowed to make changes in the MIP premiums.

The FHA provides insurance for loans on single-family dwellings, one- to four-family apartment units, medical clinics, and hospitals. The FHA also provides special subsidized programs to pay interest or rent for low- to moderate-income families.

The FHA requires borrowers to qualify for loan payments with monthly housing expense limited to 31% of their total monthly gross income, and the total housing plus long-term debt expense cannot exceed 43% of gross monthly income. Compensating factors may be taken into account.

The FHA has special programs, such as the Good Neighbor Next Door and 203(k) rehabilitation loan programs, that provide funds to repair newly purchased homes. Making Home Affordable programs have been developed to help borrowers struggling to make their mortgage payments by refinancing with an FHA mortgage loan.

The Serviceman's Readjustment Act, or the GI Bill of Rights, guarantees lenders making real estate loans to eligible veterans that the Department of Veterans Affairs (VA) will pay if the borrower defaults. To be eligible for the loan guarantee, a veteran must meet specific guidelines as to time of service in war and peace time. Reservists and National Guard members are also included, as are unremarried spouses of deceased veterans.

The VA guarantees the top 25% of the current conforming loan limit. In the event of a default, the lender would receive the guaranteed amount from the VA and sell the property to recover the balance owed.

The VA allows the borrower to negotiate for market interest rates. In addition, the borrower may finance all funding fees. Either borrowers or sellers can pay the discount points, and the seller can pay all closing costs. A VA appraisal is provided under a certificate of reasonable value. This appraisal is valid for 6 months for an existing property and 12 months for new construction.

To qualify for a VA loan, the veteran's monthly payments, including PITI, utilities, maintenance, repairs, and other monthly obligations, cannot exceed 41% of the month's total gross income with an amount set aside as residual income. The veteran may be released from liability on a VA loan by paying it in full, securing a release of liability from the VA, securing a substitution of entitlement from another eligible veteran, or pursuing the full substitution process of novation.

INTERNET RESOURCES

Federal Housing Administration (FHA)

www.fha.gov

www.hud.gov

Department of Veterans Affairs

www.va.gov

www.benefits.va.gov/homeloans/

REVIEW QUESTIONS

1. The important aspect of FHA loans introduced in 1934 that made them attractive to lenders was that
 - a. a purchaser could make a very small down payment.
 - b. a purchaser could borrow additional funds for closing costs.
 - c. the government insured the full amount of the loan.
 - d. the government established qualifying standards for the property.
2. The FHA is under the direct administration of
 - a. Fannie Mae.
 - b. HUD.
 - c. Congress.
 - d. Ginnie Mae.
3. The FHA protects itself against the risk of defaulting borrowers by requiring
 - a. a higher rate of interest.
 - b. a larger down payment.
 - c. a mortgage insurance premium.
 - d. low qualifying ratios.
4. The 3.5% of the sales price that must be provided by the borrower may come from any of the following sources *EXCEPT*
 - a. the borrower's savings.
 - b. a gift from a family member.
 - c. a grant from a nonprofit assistance program.
 - d. the seller.
5. An elderly couple who needs extra monthly income but does not want to have to sell their home could apply for
 - a. an Energy Efficient Mortgage.
 - b. a Home Equity Conversion Mortgage.
 - c. a Good Neighbor Next Door Mortgage.
 - d. a Housing Choice Voucher program.
6. The annual renewal premium for any FHA loan is
 - a. paid up front at closing.
 - b. financed over the life of the loan.
 - c. paid monthly as part of the PITI payment.
 - d. paid by the seller.
7. A young woman has applied for a FHA 203(k) loan. She is likely
 - a. planning to purchase and rehab a property.
 - b. looking for lower payments in the first year.
 - c. seeking an Officer Next Door loan.
 - d. planning to refinance her home mortgage.
8. Even with a 0% down payment, VA loans are acceptable to lenders because
 - a. they are insured by the VA.
 - b. the interest rates are set higher by the VA.
 - c. it is faster to obtain loan approval.
 - d. the VA guarantees the first 25% of the allowable loan.
9. The amount of entitlement for which the veteran is eligible is shown on the
 - a. DD 214.
 - b. VA Form 1068.
 - c. Certificate of Eligibility.
 - d. discharge papers.
10. If the certificate of reasonable value (CRV) is less than the contract sales price, the seller has the option to
 - a. require the veteran to pay the contract price.
 - b. accept the CRV value as the sales price.
 - c. carry back a second mortgage for the difference.
 - d. submit an independent appraisal.

11. A retired Air Force colonel wants to buy a new home using a VA loan. She used her VA guarantee of \$46,000 in 1989 when she purchased her first home. Based on a guarantee of \$104,250, she will be able to use her partial eligibility to obtain a VA loan with no money down in the amount of
 - a. \$58,250.
 - b. \$233,000.
 - c. \$359,650.
 - d. \$439,120.
12. The VA protects itself from the risk of borrower default by charging
 - a. a mortgage insurance premium.
 - b. private mortgage insurance.
 - c. a funding fee.
 - d. an extra point origination fee.

Processing Real Estate Loans

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- discuss the impact of credit scoring on obtaining loan approval;
- describe the direct sales comparison, cost, and income capitalization approaches and how an appraiser may reconcile them to determine value;
- define a cloud on the title and how it is resolved;
- identify the costs that may be involved in the closing of a real estate loan;
- define impound (or escrow) funds and how they are collected; and
- explain the types of title insurance and how payment is made.

abstract of title

actual notice

appraisal

assets

broker price opinion (BPO)

capitalization rate

Closing Disclosure

cloud on the title

constructive notice

cost approach

credit report

credit score

depreciation

direct sales comparison approach

drive-by appraisal

FICO

financial statement

gross rent multiplier (GRM)

income approach

liabilities

Loan Estimate

market value

net worth

reconciliation

suit to quiet title

survey

title insurance

title report

Torrens Certificate

tri-merge credit report

underwriting

value in exchange

value in use

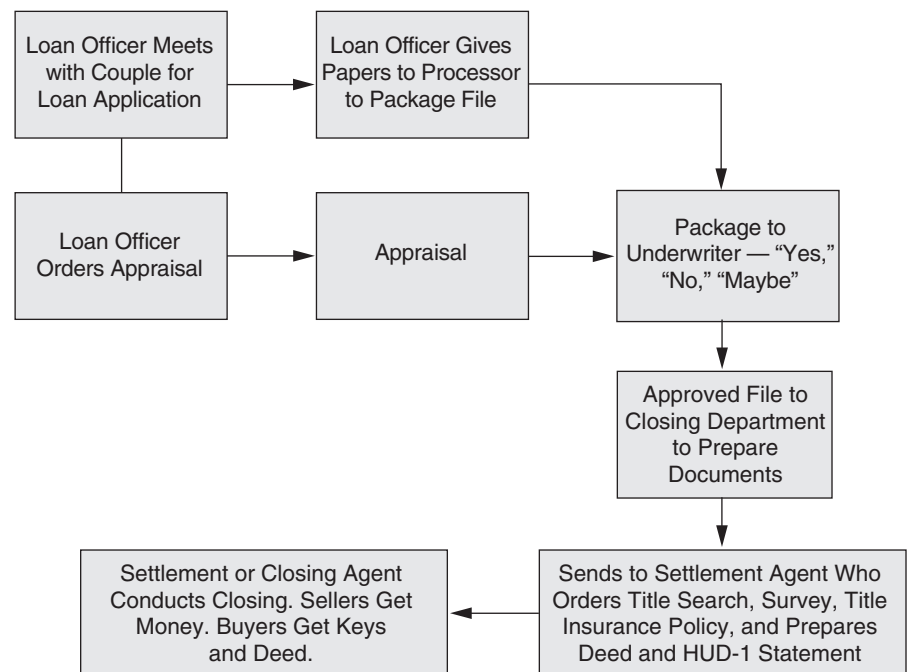
weighted average

Processing a loan for mortgage lending includes at least four basic procedures:

1. Determine the ability of a borrower to repay the loan.
2. Estimate the value of the property being pledged as collateral to guarantee this repayment.
3. Research and analyze the marketability of the collateral's title.
4. Prepare the documents necessary to approve and close the loan transaction (see Figure 9.1).

In the past, students of real estate finance frequently debated the order of importance of the first two procedures. Some said that the ability of a borrower to make payments should be the determining factor in granting a loan. Others insisted that because a borrower's payment ability can fluctuate with attitude, health, luck, and other events beyond the borrower's control, that the value of the collateral is the only truly consistent input and should be the pivotal factor in all real estate loan decisions. Recently, the emphasis has shifted to a risk assessment of the borrower's history of making timely payments on all financial obligations.

FIGURE 9.1 The Loan Approval Process



Loan **underwriting** is the evaluation of the risks involved when issuing a new mortgage or deed of trust. This process determines whether a particular borrower and the subject property meet the minimum requirements established by the lender, investor, or secondary market in which the loan will probably be sold.

QUALIFYING THE BORROWER

Prior to the advent of high loan-to-value (LTV) ratios and long-term loan amortization, little emphasis needed to be placed on a borrower's ability to repay a real estate loan. Loans were created at 50 to 60% of a collateral property's value and were based on a payment of interest only for certain short specified periods, usually one to five years. The entire principal was due in full at the stop date. If the principal could not be paid in full, partial payment could be made and the balance of the loan amount recast for an additional five years. This five-year rollover pattern could continue until the debt was paid in full. However, if a borrower did not meet the payment obligations promptly and in the amount called for in the contract, the collateral was quickly foreclosed and sold for an amount sufficient to recompense the lender.

This repayment pattern has not changed much despite the 30-year amortization schedules and regular monthly payments of principal and interest that are the framework of our current real estate financing system. The average age of a real estate loan is still only seven to eight years. What has changed, and quite dramatically, are the LTV ratios. From the original 50% LTV, this ratio grew to up to 100% or more of a property's value. One outcome of the 2007 financial crisis was a return to lower LTV ratios, requiring larger down payments. In most cases, conventional loans now require a minimum of 5% down, and mortgage insurance is required for any loan with an LTV higher than 80%. The lenders' emphasis has shifted from relying on the successful foreclosure sale of the collateral to protect the investment to looking to the borrower's ability to repay the loan.

While lenders under guaranteed or insured programs of real estate finance do not directly bear the risks of default, they still must follow the guidelines of their guaranteeing agencies. They must carefully screen loan applicants to derive some reasonable estimate of not only the ability of borrowers to pay but also their attitudes about meeting their contractual obligations responsibly. A great effort is made to thoroughly check and evaluate a potential borrower's past credit history and current financial status in order to predict future economic stability.

Loan Application

Every formal real estate loan processing procedure begins with a borrower completing a standardized loan application form and submitting it to a prospective lender. All loan application forms identify the property to be pledged, the borrower, and the amount of money requested. Additional facts about the prospective borrower are also included, along with information about the loan sought. Most loan applications show the borrower's employment and income record, a statement of assets and liabilities, and a list of credit references.

An application for a commercial or an industrial loan requires even more information than one for a residential loan. The borrower might be requested to supply such data as rent schedules or tenants' lease terms. In cases of commercial and industrial borrowers, the application form will usually outline every phase of the borrower's present business, such as management; sales; production; purchasing; research and development; personnel, plant, and equipment, and include financial statements and audits of the total operations of each phase. A Dun & Bradstreet credit report might be required. These financial statements would go back a number of years to give perspective to the general market profile of the borrower corporation and show the pattern of asset-liability ratios over a sufficient length of time. From these past profit and loss statements, the lender should be able to assess the corporation's profitability, the effectiveness of its management, and the prospects for future corporate growth.

All loan applications are designed to reveal a borrower's financial ability to meet the basic obligations of the loan agreement (see Appendix G for a typical residential loan application). The bulk of the application is devoted to securing personal information from the borrower about family size and ages of dependent children, sources of income, employment history, and a comprehensive financial statement.

Financial Statement. **Financial statements** follow a standard format that lists all assets and liabilities. This enables a lender to measure the current financial status of an applicant quickly and efficiently.

Assets consist of all things of value, encumbered or not, owned by the applicant—and cash heads the list. Cash consists of money in hand, money on deposit in checking and savings accounts, and the cash given as a deposit on the property being purchased. Lenders place great weight on a borrower's cash position as a reflection of liquidity and money management habits. A strong cash balance develops a sense of confidence in a borrower's ability to maintain payments and meet other obligations, even in the event of temporary setbacks.

Next in the financial statement asset column, all monies invested in stocks and bonds, notes or accounts receivable, personal business ventures, and other real estate are listed. The value of the applicant's automobiles, surrender value of life insurance policies, other personal property, and all other assets are enumerated. The dollar amounts assigned to these items must reflect their realistic current value, not their purchase price or some imagined value.

When more than one bond, stock, or parcel of real estate is owned, additional spaces are provided for their itemization. Should the applicant need more space than is provided, additional pages will be affixed to this inventory to fulfill these important requirements.

Liabilities consist of all monetary obligations of the borrower-applicant. Heading the list of liabilities are any notes payable because these are considered a priority claim against cash assets. Next in order of importance are all installment accounts, such as charge accounts and automobile payments. Other accounts payable, such as medical bills or insurance premiums, follow the list of installment accounts. Remaining long-term liabilities are then enumerated: alimony and child support payments, any encumbrances on the real estate listed as assets, accrued and unpaid real estate property and/or income taxes, security obligations on personal property such as furniture, loans on the life insurance policies listed as assets, and any other debts for which the applicant is responsible.

It is hoped that the total of the assets will exceed the total of the liabilities, with the difference being an applicant's **net worth**. The amount of net worth is added to the total liabilities in order to balance both sides of the financial statement. A two-to-one current ratio indicates that the applicant has twice as many current assets as current liabilities and is a good credit risk. If total liabilities exceed an applicant's total assets, a loan would probably be denied at this point and the file closed. Assuming an applicant has a positive net worth, a series of related actions begin.

Data Verification

Under Fannie Mae's automatic underwriting system, Desktop Underwriter®, and Freddie Mac's Loan Prospector®, much of the data involved in analyzing a potential loan is available from credit reporting agencies like Experian, Equifax, and Transunion. Some larger lenders, such as Wells Fargo, use their own automated underwriting systems (AUSs), programmed to meet Fannie Mae's and Freddie Mac's approval.

The loan officer charged with processing the loan verifies the information included in the application by actually checking with the various references given, the banks where deposits are held, and the applicant's employer. Some lenders will accept alternate documentation, pay stubs, bank statements, and so on, to speed up processing.

Deposits. The borrower is obliged to sign deposit verification forms (see Appendix H) that authorize the bank to reveal to the lender the current balances in the borrower's accounts. Without a verification form, such confidential information could not be released by the bank under the Federal Right to Privacy Act.

A deposit verification permission form must be signed by the borrower for each bank account to enable the loan processor to ascertain all the current balances. The knowledge that the loan processor can verify account amounts is usually enough incentive for the borrower to be truthful in reporting financial information. When the deposit balances are verified, the appropriate entries are made in the applicant's file. In some cases, the lender will accept two months of current bank statements.

Employment. Likewise, an applicant is required to sign an employment verification form (see Appendix I). It authorizes the employer to reveal confidential information concerning the applicant's job status. Not only are an applicant's wages and length of employment verified, but the employer is requested to give a prognosis for continued employment and prospects for advancement.

Credit Report. Simultaneously, with the gathering of financial and employment information, a loan processor sends a formal request for a borrower's **credit report** to a local company offering this service. Within a few days if the applicant is a local resident, or longer if out-of-town credit must be checked, the credit search company sends the loan officer a confidential report on its findings. See Appendix J for a sample credit report.

The credit report is an itemization of the status of current accounts. In addition, it indicates the quality and dates of the payments made and their regularity, delinquency, or any outstanding balances. This payment history is the most important part of the entire report. Credit managers and loan officers frequently state that a person's future attitude is in most cases a reflection of past behavior in meeting financial obligations. Research tends

to reinforce these opinions, indicating that slow and erratic payers generally retain those attitudes when securing new loans, and prompt and steady payers are also consistent in meeting their future obligations.

When a credit report is returned revealing a series of erratic and delinquent payments, the loan is usually denied at this point and the file closed. If there are only one or two unusual entries in a group of otherwise satisfactory transactions, the applicant is asked to explain these variations, noted in writing to be kept for future reference.

As with many standardized procedures, credit reporting has become computerized, dramatically shortening the time needed for completing a check. Credit reports should be used only by the persons or institutions requesting the information and only for the purposes stated.

Most credit agencies insist on seeing a buyer's written permission before issuing any information in order to protect the buyer's confidentiality. After the deposit and employment verifications are returned with acceptable information and a favorable credit report is obtained, the lending officer makes a thorough credit evaluation of the data collected.

Credit Score

Credit scores are not based on age, race, gender, religion, national origin, marital status, current address, or receipt of public assistance. As shown in Figure 9.2, credit scores are based on factors such as how you pay your bills, how much outstanding debt you have, what type of credit and how long you have had established credit, and how many times you have had inquiries relative to extending credit.

The **FICO** score (named after Fair, Isaac and Company, the San Rafael, California-based firm that created the test) assigns relative risk rankings to applicants based on statistical analyses of their credit histories. FICO scores range from 300 to 850, with most people scoring in the 600s or 700s. As shown in Figure 9.3, applicants who always pay their bills on time and make moderate use of their credit cards receive the highest scores—700 to above 800. Applicants who are late in paying bills present greater risks and receive lower scores, ranging from 400 to 620.

FIGURE 9.2 Factors That Influence an Applicant's Credit Score

Payment History—How has the applicant paid debt?

Outstanding Debt—How many loans and open charge accounts does the applicant have?

Credit History—How long has the applicant had credit?

Credit Inquiries—How many times has the applicant authorized a credit check?

Types of Credit—What types of credit does the applicant have?

FIGURE 9.3 Credit Scoring and Applicant Characteristics

Low 400s to Low 600s	620 to High 800s
<ul style="list-style-type: none"> • Late in paying bills • Has many credit cards • Too many credit inquiries • Has “maxed out” credit cards 	<ul style="list-style-type: none"> • Pays bills on time • Makes moderate use of credit card(s) • Pays off debt rather than moving to another card

The FICO score is based on the following percentages:

- Payment history = 35%; late payments, bankruptcies, and other negative items hurt score, but on-time payments help score.
- Amount owed = 30%; amount owed on all accounts, number of accounts with balances, and how much of available credit is being used.
- Length of credit history = 15%; longer credit history increases score, but shorter history not detrimental if good credit record established.
- New credit = 10%; multiple search for mortgage loan should be done within 30 days.
- Other factors = 10%; mix of credit types (credit cards, mortgage or car loan, and personal lines of credit can add to score, while maxed out credit cards can lower score).

Another result of tightened qualifying standards is the requirement for a higher credit score. Just as lenders are raising the acceptable credit score, millions of potential homebuyers are seeing a significant drop. FICO reports that over 50 million consumers saw anywhere from a 20 to 50 point drop in their score in 2008 and 2009. Being three months late on a loan could cost 130 points, and a short sale with a deficiency balance could cost up to 160 points. FICO also reports that it can take as much as 30 to 36 months to recover a 70- to 110-point drop in score. In November 2011, the National Association of REALTORS® released a survey stating that 33% of members surveyed reported contract failures, mostly due to credit issues. This was a jump from 8% in a similar survey taken just a year previously.

According to Ken Harney, real estate reporter for *The Washington Post* Writer’s Group, average FICO scores for loans originated for sale to Fannie Mae or Freddie Mac in 2011 ranged at 760 or above. Even borrowers using FHA mortgages are showing average scores of around 700.

FICO has announced plans to start using a new credit formula in 2014 that may help bring up scores. Some of the changes include the following:

- A debt that goes to collection and is paid off will no longer affect the score.
- Medical debts in collection will not count as heavily as in the past.
- New methods will be employed for those without a long history of borrowing.

Obtaining Your Credit Report

As of September 2005, everyone has the right to one free credit report per year from each of the three major credit reporting agencies:

Equifax	800-685-1111	www.equifax.com
Experian	866-200-6020	www.experian.com
TransUnion	800-888-4213	www.transunion.com

Congress has established the Annual Credit Report Request Service to make it easier for consumers to obtain credit reports and credit scores (see www.annualcreditreport.com). By ordering one report every four months, a consumer can receive all three free reports within one year. To receive the actual credit score, a small fee must be paid.

FICO also offers free newsletters with product discounts, free educational presentation, and timely topics dealing with credit issues through its website at www.myfico.com.

Lenders may order credit scores electronically at relatively low cost from credit repositories or bureaus. Most lenders today order a **tri-merge credit report** containing information from all three of the major credit repositories. In most cases, the numerical credit score will be different on all three reports due to variations in time and content from creditors. Generally, the lender will use the middle score, not an average.

Potential misuse of credit scoring has prompted the following rules on their use:

- Never automatically disqualify applicants because of a subpar credit score (credit scores may not single out or prohibit low- to moderate-income borrowers from becoming homeowners).
- Be aware of potential errors in electronic credit files.
- With a subpar score, look hard at the score factor codes and work with the applicant to clear fixable items.

Income Evaluation

Not only is the quantity of an applicant's income evaluated for loan qualification, its quality is evaluated as well. The lender is looking for income that is stable, regular, and recurring. Thus, income from all sources is added together to find an acceptable total on which to apply the qualifying ratios.

In a normal transaction, the wages and earnings of the co-borrowers are considered. In the event a cosigner is involved, this person's income is included as well. Extra income is considered if it is received regularly and for a period of at least three years; thus, bonuses and overtime pay can be included if they fit this criterion. Pensions, interest, and dividends are treated as regular income, although it is recognized that interest and dividends do fluctuate over time and may cease if the investment is cashed out.

A second or part-time job is accepted as part of the regular monthly income if it can be shown that the job has existed for approximately two years and there is good reason to believe it will continue. Child support can also be included in the determination of monthly income, but only if it is the result of a court order or has a proven track record. Also, under the Equal Credit Opportunity Act (ECOA), government entitlement funds

must be considered. Self-employed borrowers, including commissioned wage earners, need at least two years of established income to qualify for a mortgage loan.

Divorced buyers are required to submit a copy of their decree to inform lenders which party is responsible for liabilities, how the assets are divided, and whether there are support and/or alimony obligations. For alimony to be considered as income, most lenders require a one-year history of payment receipts and reasonable assurance that payments will continue for at least three years from the date of the loan application.

On the other hand, alimony or child support payments are considered a debt of the borrower responsible for these and must be included in the financial analysis.

On the Verification of Employment, an applicant's employer is asked for an opinion of job stability and possible advancement. Length of time on the job no longer carries the heavy clout it once did. Applicants whose employment records show frequent shifts in job situations that result in upward mobility each time are given full consideration. Lenders will, however, be wary of an applicant who drifts from one job classification to another and cannot seem to become established in any specific type of work.

Loan Qualifying Income Ratios. When analyzing the borrower's ability to make the required loan payments, loan underwriters generally apply the following pairs of income ratios (although higher ratios may be considered with different loan products):

Loan Type	Housing Ratio	Total Debt Ratio
Conventional loans	28%	36%
FHA loans	31%	43%
VA loans	—	41%

The front-end, or housing ratio, refers to the total of principal, interest, taxes, insurance, and homeowners' or condominium association fees as a percentage of gross monthly income. The back-end, or total debt ratio, refers to the total of the mortgage payment plus other monthly installment obligations, such as car, credit card, or student loan payments, as a percentage of gross monthly income. Some flexibility exists in this latter category, such as eliminating a scheduled payment that will end in ten months or less.

■ **FOR EXAMPLE** Consider a conventional loan of \$250,000 at 6% interest for 30 years using 28/36 ratios. The property taxes are \$3,600 per year, and the homeowners insurance premium is \$480. The homeowners association fee is \$240 for the year. The borrowers have a car payment of \$400 per month, with two years left to pay.

\$250,000 @ 6% for 30 years:	
Principal and Interest	\$1,498.90
Property Taxes	300.00
Homeowners Insurance	40.00
HOA Fee	<u>20.00</u>
Monthly Payment	\$1,858.90
Housing Expense Ratio	÷ 28%
Required Gross Monthly Income	\$6,638.93

Monthly Payment	\$1,858.90
Car Payment	<u>400.00</u>
Total Housing + Debt Payment	\$2,258.90
Total Debt Ratio	\div <u>36%</u>
Required Gross Monthly Income	\$6,274.72

Because the required income to satisfy the total debt ratio is less than that required by the housing expense ratio, the \$6,638.93 would apply. The housing expense may not exceed the given ratio. The total debt ratio only affects the required monthly income if the additional long-term debt is higher.

If the borrowers had \$800 in car payment debt, the Total Housing + Debt Payment would be \$2,658.90; divided by 36% = \$7,385.83 required monthly income.

■ **FOR EXAMPLE** The following is an example of a VA loan using the same total housing and debt payment. Divided by the VA 41% ratio, the required monthly income is less.

Monthly Payment	\$1,858.90
Car Payment	<u>400.00</u>
Total Housing + Debt	\$2,258.90
VA Housing and Debt Ratio	\div <u>41%</u>
Required Monthly Income	\$5,509.51

Because VA loans only use one ratio of 41%, less income is required. Neither of the previous examples takes into account mortgage insurance or a VA Funding Fee. Most conventional loans are based on automated underwriting and may result in higher ratios than the 28/36 standard.

After reviewing all the information provided in the loan application and making the appropriate ratio analyses of the income and expense data, plus the borrower's FICO score, the loan officer collects all pertinent papers and sends the package to the company underwriters for a final determination. If a special report of unusual circumstances is warranted, it is included. During the borrower's qualification process, an appraiser is evaluating the collateral, and this appraisal report is included in the submission.

QUALIFYING THE COLLATERAL

Despite the current trend toward emphasizing a borrower's financial ability as the basic loan-granting criterion, real estate lenders and guarantors are practical and fully understand that life is filled with unpredictable, uncontrollable events. A family's breadwinner can die. Negative economic activities in a particular geographical area can exert devastating financial impacts. Applicants can be left unemployed due to layoffs. Personal decisions can result in bankruptcies and divorces, often damaging or destroying credit in the process. To hedge these risks and others, real estate lenders look to the value of the collateral as the final assurance for recovery of their investments in a default situation. Therefore, an accurate estimate of the value of this collateral becomes another pivotal point in the lending process.

Definition of Value

Value is defined as the ability of an object to satisfy, directly or indirectly, the needs or desires of human beings. As such, economists call it **value in use**. When the value of an object is measured in terms of its power to purchase other objects, it is called **value in exchange**.

From these definitions, it is apparent that value is a function of use and demand. As such, value is subjective by its very nature. A seller may have an entirely different idea of a property's value than a potential buyer. A condemning agency would probably offer a different opinion of a property's value than its owner. Tax assessors and property owners disagree about a particular property's value, as do many other persons under varying circumstances. However, an appraiser must make an objective estimate of value based on supply and demand in the marketplace.

In Practice

A married couple recently made an offer on a house near the husband's office. Their offer of \$140,000 was accepted with a \$7,000 down payment and a 95% LTV mortgage loan of \$133,000. As first-time homebuyers, the couple thought that was all they needed to start packing for the move to their new home. Over the past few weeks, they have learned a lot about the possible pitfalls between the time of a contract acceptance and a successful closing.

First, in qualifying for their loan, they were surprised to learn that they have accumulated too much credit card debt. The lender is requiring that they pay off the outstanding balances and close out three of their credit cards.

They never realized that the property itself had to qualify. When the appraisal came in at \$138,000, the lender was no longer willing to give them a mortgage loan of \$133,000. As the couple does not have the extra cash to make up the difference, they were greatly relieved when the seller eventually agreed to reduce the sales price to \$138,000, leaving the down payment at \$7,000 with a \$131,000 loan.

With settlement only four days away, the couple thought they were all set when an unexpected call came from their agent telling them that the title search had come up with a cloud on the title—an outstanding mechanic's lien for \$3,500 was still recorded on the property. Fortunately, the sellers have cancelled checks showing that the contractor who replaced the roof three years ago was in fact paid in full, although there had been lengthy arguments about the quality of the work, which had delayed payment.

Finally, 30 days since acceptance of their offer, the couple is scheduled for settlement with borrowers, collateral, and title all satisfactorily qualified.

There can be only one market value for a specific real property at any given point in time. **Market value** is the price a property would most likely bring if it were exposed for sale in the open market for a reasonable period of time. Implicit in this definition is that both buyer and seller are well informed and under no undue pressure to influence the decision of either party.

In terms of market value, it is important to note the fine distinctions that exist among cost, price, and value. Cost, a measure of past expenses, may not reflect current market value, especially if a building is fairly old. Price, on the other hand, is a present measure but one that may be affected by some unusual circumstances of a specific transaction. Unique financing terms or a temporarily active local housing market in which potential buyers briefly exceed available properties may cause prices to rise. Therefore, each parcel of property pledged for collateral must be inspected and appraised carefully to estimate its fair market value because this amount will be employed as the basis for determining the mortgage loan amount. Depending on the type of loan to be issued and its concurrent LTV ratio, either the amount of the formal appraisal made as part of the loan process or the purchase price, whichever is less, will determine the amount of the loan.

Appraiser Independence Requirements

An **appraisal** is the estimate of a property's value at a specific point in time. It must be reported in writing, in accordance with the *Uniform Standards of Professional Appraisal Practice (USPAP)*, using the Uniform Residential Appraisal Report (see Appendix K), by competent individuals whose professional integrity is beyond reproach.

As of October 15, 2010, all conventional, single-family (one- to four-unit) loans must comply with the Appraiser Independence Requirements (AIR). AIR applies only to loan origination, not to foreclosure, workouts, or any type of mitigation. All lenders are required to select an appraiser who meets the following:

- Selected in compliance with AIR
- Certified or licensed in the state where the property is located
- Familiar with the local market, competent to appraise the subject property type, and has access to the data sources needed

Lenders can choose from a rotating roster of appraisers, but this is not required. Appraisers may also be selected from a preapproved list or panel as long as any employee of the lender involved in the selection is independent of the loan production staff.

The Federal Housing Finance Agency (FHFA) issued new appraisal standards that took effect in July of 2012. The Uniform Appraisal Dataset (UAD) was created to improve the quality and consistency of appraisals on mortgages to be sold to Fannie Mae and Freddie Mac. The FHA and the VA are expected to adopt the UAD or something similar. There are a number of appraisers' associations: the Appraisal Institute, the American Society of Appraisers, the National Association of Independent Fee Appraisers, and the National Association of Review Appraisers and Mortgage Underwriters. Some of these groups maintain active education programs and award achievement designations for completing a number of formal courses and for serving a number of years as an appraiser. For example, the Appraisal Institute offers the Member Appraisal Institute (MAI), Senior Residential Appraiser (SRA), Senior Real Estate Appraiser (SREA), and Senior Real Property Appraiser (SRPA) designations.

The methods of appraisal are predominantly mathematical. Nevertheless, an appraiser relies on personal interpretive skills to a great degree. Appraising is, therefore, a science that is artfully interpreted.

The Appraisal Process

In most appraisals, the appraiser comprehensively examines the property and provides a detailed description of its attributes and shortcomings. Sometimes an appraiser performs a **drive-by appraisal** of the property when more detail is not required. Drive-by appraising involves the appraiser literally driving by the property for a quick inspection to form an opinion of its outward appearance. If it appears to be well-kept and in good condition, it is assumed that the interior is also well-maintained, and the appraisal will be made on the square footage and location. If, on the other hand, the property looks worn and not well-kept, the drive-by appraiser's report would reveal this information and include a recommendation for a more comprehensive examination or even a denial of the loan. In some cases, a lender may request a **broker price opinion (BPO)**, which is not to be confused with an appraisal. A BPO may consist of a drive-by appraisal plus available computer information.

The appraisal process generally includes defining the appraisal problem, determining the purpose for the appraisal, examining the neighborhood and property being appraised, collecting the pertinent data, applying the appropriate approaches to estimate value, reconciling these value estimates, and preparing the appraisal report.

The single most important skill in appraising is the collection of data pertinent to the problem. The appraiser estimates value primarily by carefully examining the subject property and comparing it with properties that have like features (comparables, or comps). The appraiser must not only seek to find properties similar to the subject property in age, size, physical condition, location, and zoning, but must gather recent relevant data about these comparable properties to help estimate the value. The estimate of value will be based on the appraiser's opinion of the subject property's probable worth as a result of skillfully interpreting the data acquired from the most appropriate appraisal approach.

Three basic approaches are used to arrive at an estimate of a property's value. These three techniques—the direct sales comparison approach, the cost approach, and the income approach—will be described in general terms here.

Direct Sales Comparison Approach

The **direct sales comparison approach** is based on a comparison of the subject property with similar properties in the same locale that have sold recently. An appraiser searches the records of the county recorder's office and the various multiple listing services and maintains a comprehensive and current filing system. Thus, the appraiser is usually able to discover the sales prices and terms involved in recent transfers of properties similar to the property being appraised (see Figure 9.4).

The proficiency of an appraiser is never more clearly tested than in the direct sales comparison approach. Training and experience must be employed artfully to interpret, evaluate, and reconcile the data collected from comparable sales into a dollar amount that represents the subject property's value. No two properties are exactly alike; the appraiser must make many subjective adjustments to the sales prices of the comparable properties (comps) to more clearly reflect the subject property's worth. The reasons for the various differences in the sales prices of comps must be determined and their prices adjusted to reflect what they would have sold for had they more exactly matched the subject property.

FIGURE 9.4 Sales Comparison Approach to Value

	Subject Property	Comparable Properties		
		A	B	C
Sales price		\$260,000	\$252,000	\$265,000
Financing concessions	none	none	none	none
Date of sale		current	current	current
Location	good	same	poorer +6,500	same
Age	6 years	same	same	same
Size of lot	60' × 135'	same	same	larger –5,000
Landscaping	good	same	same	same
Construction	brick	same	same	same
Style	ranch	same	same	same
No. of rooms	6	same	same	same
No. of bedrooms	3	same	poorer +500	same
No. of baths	1½	same	same	better –500
Sq. ft. of living space	1,500	same	same	better –1,000
Other space (basement)	full basement	same	same	same
Condition—exterior	average	better –1,500	poorer +1,000	better –1,500
Condition—interior	good	same	same	better –500
Garage	2-car attached	same	same	same
Other improvements	none	none	none	none
Net adjustments		–1,500	+8,000	–8,500
Adjusted value		\$258,500	\$260,000	\$256,500

Note: The value of a feature that is present in the subject but not in the comparable property is *added* to the sales price of the comparable. Likewise, the value of a feature that is present in the comparable but not in the subject property is *subtracted*. A good way to remember this is: CBS stands for “comp better subtract”; and CPA stands for “comp poorer add.” The adjusted sales prices of the comparables represent the probable range of value of the subject property. From this range, a single market value estimate can be selected.

For instance, the appraiser must be able to estimate what the sales price of a comp would be if it were the same age, condition, style, floor plan, size, location, and material as the subject property and also what price it would bring on the day of the appraisal, rather than at the time of its actual sale, six months or a year ago. The appraiser must make these adjustments, all of which involve judgments based on experience, in order to estimate the subject property’s value more accurately. An appraiser’s efforts depend on the magnitude of the loan and the degree of risk involved. These efforts can expand from a mere impression of value, as discerned by a drive-by examination of the subject property and a recollection of other similar properties recently sold, to a massive report based on 10 comparables, 15 comparables, or even more. Each comparable is adjusted for significant variables to reflect the subject’s value. These comprehensive appraisals are made easier by the increasing use of computer technology.

Because of the current credit crisis, appraisers are cautioned to pay particular attention to foreclosed properties and their impact on the values of other properties in the neighborhood when applying the direct sales comparison approach.

Cost Approach

The cost approach method of estimating a property's value is based on the current value of its physical parts. In the **cost approach** an appraiser examines and evaluates the subject property, its improvements, amenities, and land value. This technique includes an estimation of the current cost to reproduce the improvements, an estimate of the improvements' depreciation, and an estimate of the land value as derived by using the direct sales comparison approach.

An appraiser accumulates data about the current cost of building the subject property. If the property is actually newly constructed, its plans and specifications are reviewed and analyzed to estimate its value. An older property requires an examination of its design and composition to estimate its current reproduction cost. Obviously, the cost approach works best with recently built or unique properties, such as a church or museum.

When used properties are appraised, a depreciation allowance must be applied to the costs of reproduction. This depreciation adjustment is based on the rule of substitution, which states that no rational, economical person would pay the same price for a used property as for the same property when new.

Depreciation is a lessening in value from physical deterioration, functional obsolescence, or economic obsolescence. An example of physical deterioration is an older roof that may need patching or replacement. Functional obsolescence describes a situation in which access to one bedroom is available only through an adjoining bedroom. An example of economic obsolescence is a location downwind from a sewage treatment plant. The appraiser must include in the adjustments a consideration of the present physical condition of the improvements, their functional utility, and the effects of forces outside the property on its value.

After the reproduction cost is calculated and adjusted to allow for depreciation of the improvements, the value of the land, as determined by the direct sales comparison approach, is added to the depreciated figure to arrive at an estimate of the total property value. The cost approach in formula form is as follows:

$$\begin{array}{r} \text{Current replacement cost of improvements} \\ - \text{Depreciation} \\ \hline \text{Estimate of current value of improvements} \\ + \text{Amenities and land value} \\ \hline \text{Estimate of current value of property} \end{array}$$

■ **FOR EXAMPLE** A 10-year-old house with an estimated 50-year life consists of 1,800 square feet, with a current reproduction cost factor of \$100 per square foot. If the lot is worth \$50,000, the estimate of property value using the cost approach is \$194,000.

1,800	Square feet
× 100	Reproduction cost
180,000	Value of improvements when new
× 0.80	Straight-line depreciation reciprocal
144,000	Depreciated value of improvements
+50,000	Lot value
\$194,000	Estimated property value

Income Capitalization Approach

The income approach measures the value of a property on the basis of its ability to generate income by capitalizing the net annual income using a current market **capitalization rate**. In other words, the **income approach** actually measures the present worth of a property's income stream based on an investor's required rate of return.

This method is best suited to estimating the value of apartments, stores, shopping centers, and office buildings. The first factor an appraiser determines is the property's annual gross market income. Although a subject property may have an established rental income, an appraiser must verify whether this income is based on market rents or rents that are higher or lower than the market rate. Thus, the direct sales comparison approach is first employed to locate similar properties and analyze their rental schedules.

After the gross annual rental income has been determined, an appropriate amount must be deducted for operating expenses such as property taxes, insurance, maintenance, vacancy allowances, management, utilities, pest control, snow removal, accounting services, and advertising. Although depreciation is not considered an operating expense per se, most appraisers will include an item called reserves for replacements or reserves for major repairs. An income property should be able to support itself in every way to substantiate its value.

A net annual market rental income is derived when the operating expenses are deducted from the gross annual market rent. This net rental income is the amount that is capitalized into an estimate of the property's value using the formula:

$$\text{Value} = \frac{\text{Net Income}}{\text{Capitalization Rate}}$$

■ **FOR EXAMPLE** Consider an apartment house generating \$250,000 gross annual income. Operating expenses, including vacancies, total 45% of this income. In a market that supports a 10% capitalization rate, this property is worth \$1,375,000 using the income approach.

Gross Annual Income	\$250,000
Operating Ratio Reciprocal	<u>× 0.55</u>
Net Operating Income	137,500
Capitalization Rate	<u>÷ 0.10</u>
Estimate of Value	\$1,375,000

Gross Rent Multiplier (GRM)

When estimating the value of single-family or small commercial and industrial properties, a **gross rent multiplier (GRM)** is often used. The GRM is derived by locating comparable properties that have sold recently, then dividing their sales prices by a monthly market gross rent to derive the multiplier. For an example of a GRM, see Figure 9.5.

Reconciliation of Data and Opinion of Value

After applying the preceding approaches pertinent to the estimate of a particular property's value, an appraiser reviews the results, reconciles or correlates the different values derived, and renders a written opinion of the property's value. This opinion may place more emphasis on one approach than another. For instance, the cost approach is more reliable when appraising a newer property than an older one. The income approach is more valid with true income property rather than with houses or vacant land on which an appraiser must impute a fictitious "rent" before this approach can be applied. The direct sales comparison approach supplies the balancing aspect to an appraisal, frequently providing the middle value in a spectrum where the cost approach is invariably high and the income approach is usually low. The direct sales comparison approach is also an integral part of the other two approaches. It is used in the cost approach to determine the value of the land and in the income approach to help derive the net annual market rental income

FIGURE 9.5 Gross Rent Multiplier

Comparable No.	Sales Price	Monthly Rent	GRM
1	\$280,000	\$1,800	155.55
2	243,000	1,350	180.00
3	287,000	2,000	143.50
4	262,500	1,675	156.72
Subject	?	1,750	?

Note: Based on an analysis of these comparisons, comparables 1 and 3 show extremes. Based on monthly rent between comparables 1 and 4, a GRM of 156.72 seems reasonable for homes in this area. In the opinion of an appraiser, the estimated value of the subject property would be $\$1,750 \times 156.72$, or \$274,260.

to be capitalized. One way of **reconciliation** is to apply the **weighted average** technique, which assigns percentages to illustrate the importance of one approach over another.

■ **FOR EXAMPLE** If an appraiser finds that the market, cost, and income approaches indicate \$200,000, \$210,000, and \$220,000, respectively, and the appraiser weights them 50%, 30%, and 20%, respectively, the reconciliation will be \$207,000.

$$\begin{array}{r}
 \$200,000 \times 0.50 = \$100,000 \\
 210,000 \times 0.30 = \quad 63,000 \\
 220,000 \times 0.20 = \quad \underline{44,000} \\
 \qquad \qquad \qquad \$207,000
 \end{array}$$

When an appraisal is completed, it is delivered to the loan officer to aid in the final loan decision. As noted previously, a loan amount is based on the lesser of either this appraised value or the sales price of the property.

QUALIFYING THE TITLE

Anticipating a new loan, the loan processor secures a **title report** on the collateral, which includes a search of the records to determine all the interests in a property. Normally, property interests are perfected through the appropriate filing and recording of standard notices. A recorded deed notifies the world that a grantee has the legal fee title to the property. A recorded construction lien is notice of another's interest in a property. These forms of recording are described as **constructive notices**, an express revelation of a fact.

Another form of notice, one that is imputed by law, is described as an **actual notice**. Even if a buyer does not actually inspect the house that is in the process of being purchased, its occupants have displayed their claim to certain rights merely through their physical possession of the property, even if they have not recorded that interest. The buyer is presumed to know of the occupants' interest in the property, as this information is available through ordinary inquiry. Similarly, even if a person does not actually view the recorded information, it is presumed to be known by actual notice because it is there for the viewing.

At least three methods are employed for obtaining assurance of good title—the abstract and opinion, title insurance, and the Torrens system. Whichever method is used, the title report on the collateral provides the loan officer and the lender's attorney all recorded information relevant to the legal status of the subject property, as well as any interests revealed by actual notice. This title search requirement is yet another manifestation of a lender's efforts to protect the loan investment.

Abstract and Opinion of Title

An **abstract of title** is described as a synopsis of the current recorded condition of a property's title. Abstracting is the process of searching the records to accumulate information that is then distilled by the abstractor and presented as a formal report.

An abstract is not considered an official document because it makes no pretense of disclosing any hidden title hazards. The abstractor is responsible only for an accurate

portrayal of documents of record pertinent to a property's title status. If the loan officer wants a more complete analysis of a title, a request is made for an opinion on the condition of the collateral's title from a lawyer. This opinion is based on the facts revealed in the abstract, and all defects in the title are brought to the loan officer's attention. However, neither the abstractor who searches the title nor the lawyer who renders an opinion of the title's condition issues a guarantee or insures against defects. If the lender requires additional protection against hidden defects or possible errors in the abstracting process, a title insurance policy must be secured.

Title Insurance

Title insurance is based on risk elimination rather than risk assumption. A title insurance policy insures the quality of title on real estate as it exists on the date of the policy, but it does not insure against future events (e.g., a lien filed after the date of settlement). Consequently, most of the premium goes to investigating the history of the title.

Title companies combine the abstracting process with a program of insurance that guarantees the validity and accuracy of the title search. A purchaser of **title insurance** can rely on the assets of the insurance company to back up its guarantee of a property's marketable title. These guarantees are evidenced by policies of title insurance. Most institutional lenders require that a title policy be issued to them for the full face amount of the loan.

When a title insurance policy is issued to a lender (the insured), it is usually in the American Land Title Association (ALTA) form. While a standard title policy insures against items overlooked in the search of the recorded chain of title, an ALTA policy expands this standard coverage to include many unusual risks. Among these risks are forgeries, incompetency of parties involved in issuing documents pertaining to the transfer of ownership, legal status of parties involved in the specific loan negotiations, surveying errors, and other possible off-record defects. Some additional risks can be and usually are covered by special endorsements to an insurance policy. These might include protection against any unrecorded easements or liens, rights of parties in possession of the subject property, mining claims, water rights, and additional negotiated special items pertinent to the property involved. The expanded ALTA policy is usually required by participants in the secondary mortgage market—Fannie Mae, Freddie Mac, and Ginnie Mae—for the added protection it provides. Practitioners use the phrase “an ALTA policy” when describing an extended coverage policy.

Title Commitment

Because the wording of a title commitment may vary by state, it would be helpful to obtain a sample copy from a local title company that could be reviewed in detail. The commitment for title insurance will be based on the information obtained in the abstract of title and a search of recorded documents related to the property in question.

Torrens System

The Torrens system of title guarantees is designed to shorten the time needed to search the title. It places the insurance process in the hands of the state. Essentially, under the Torrens plan, a title is searched only as far back as the previous search. It is assumed in the process that all transactions prior to the last search were accurate and legal and that any problems that might have been revealed were resolved satisfactorily. A **Torrens Certificate** is issued, which includes the state as guarantor of the title in the event of a claim. A charge is made for this certificate to cover the costs of the search, and, in some states, an additional premium is charged to provide a reserve fund to cover any contingent losses.

The Torrens system has some advantages over the regular recording system, including saving time, eliminating the accumulation of large quantities of title evidence, and lowering the costs of title examining and insuring. Only a few states today allow registration under the Torrens Act, including Colorado, Georgia, Hawaii, Illinois, Massachusetts, Minnesota, New York, North Carolina, Ohio, Virginia, and Washington.

Title Faults

Whether the abstract and opinion, the title insurance policy, or the Torrens system is used, in all cases a property's title is searched by an experienced abstractor, who prepares a report of those recorded documents that clearly affect the current quality of ownership. In addition, a survey is sometimes required. If a fault is found, called a **cloud on the title**, the loan process will not continue until this cloud is cleared to the lender's satisfaction. Such a cloud could be an unsatisfied construction lien, an income tax lien, a property tax lien, an encroachment, or a zoning violation. Sometimes a borrower's name is not legally correct on the deed, or the deed has a faulty acknowledgment or lacks the appropriate signatures. Because of the many complexities in a real estate transaction, there are innumerable possibilities for faults to appear in a title search and property survey. It is the abstractor's responsibility to discover and report them.

In certain instances where clouds are difficult to remove by ordinary means, they will need to be cleared by the seller of the property or by the borrower filing a **suit to quiet title**. After appropriate evidence has been submitted, a judge removes or modifies an otherwise damaging fault in a title, and the loan process can continue. The assurance of good title is as essential to a loan's completion as the credit of the borrower and the value of the collateral. The sales of foreclosed properties create complexities that require scrupulous examination and careful documentation of the title's condition.

Surveys

Although many loan closings require delivery of a plat to identify the location of buildings on the lot, some lenders may require a full **survey** of the collateral property as a condition for a new loan. Although many properties are part of subdivisions that have been engineered and described by licensed and registered surveyors and engineers, some owners might have enlarged their homes or added to the improvements since the original survey. These might not meet the various setback restrictions required in the local zoning laws. Some properties might have been re-subdivided, while others might now have an encroachment problem.

Surveys often reveal errors in legal descriptions or discover encroachments and easement infractions. A few interesting lawsuits have developed as a result of the wrong property being encumbered by a new real estate loan.

CLOSING THE LOAN

Once a borrower's credit has been approved, the collateral's value is acceptable, and the legal title to the collateral is clear, the loan underwriter approves the loan and preparations for closing begin. An approved loan commitment is communicated to all interested parties, obligating the lender to issue the loan under the terms and conditions stipulated. This commitment remains in force for only a limited time, preventing any delay in the closing.

The lender's closing department prepares the various loan documents and establishes the escrow or impound account. The documents are then sent to the settlement or escrow agent who prepares the deed and the HUD-1 Settlement Statement, which shows the allocation of all charges and credits to both buyer and seller (see Appendix B).

At the closing, the settlement agent prepares the HUD-1 Settlement Statement that shows all charges and credits to both buyer and seller and the deed conveying title. After all documents are recorded, monies are distributed.

The actual closing may be handled differently in different parts of the country. In the western states (influenced by Spanish law), closing is done in escrow, with one escrow officer preparing all documents and disbursing funds and keys to the appropriate parties. In the middle and eastern states (influenced by British law), closing may be done by either an attorney or a title company settlement agent. Both buyers and sellers attend the settlement, along with the real estate agents and any additional attorneys, plus loan officers in some cases.

Additional Charges and Requirements

The seller usually pays the real estate broker's commission, although in some cases the buyers may pay for the buyer agent directly. Many states charge a transfer tax, which is a percentage of the new money involved and is paid by the seller. Both the seller and the buyer pay their appropriate share of recording fees and payment to the settlement agent.

While the borrower likely paid in advance for the appraisal, credit report, homeowners insurance, and any other required special insurance policies (such as flood insurance), these items still show up on the HUD-1 form marked POC (paid out of closing). The borrower will pay for the lender's title insurance policy and for the owner's policy, unless the property is in a state where the seller is obligated to pay for it.

Interest on the loan, property taxes, and homeowners' or condominium associations fees are all prorated to the day of settlement. In the case of income property, deposits may need to be collected and rents prorated. Some states such as Florida and Virginia hold the buyer responsible for the closing day, but in most states the seller is still considered the owner.

Servicing the Loan

Most loans today are sold or assigned in the secondary market, though the original lender often remains as the servicer for the loan. The new owner must be notified of where, when, and how mortgage payments are to be made. Usually, a coupon book is provided indicating the amount due if paid by the required date and a higher amount if paid late. The servicer collects the payments, maintains the escrow account, makes timely payments for both property taxes and homeowners insurance, and contacts the borrower in case of any default. If the loan is sold, the lender must provide the borrower with a Loan Transfer Disclosure statement containing all new information needed for timely payment on the loan.

New Rules from the Consumer Financial Protection Bureau (CFPB)

The CFPB released new rules on how mortgage servicers must treat borrowers. These rules took effect on January 10, 2014, and apply to all mortgage servicers with 5,000 or more loans. The goal of the new regulations is to make sure that servicers cannot take advantage of borrowers who fall behind on their payments.

HUD-1 Settlement Statement

The HUD-1 form summarizes the charges and credits and shows the amount due from the buyer and credit to the seller, usually required to be in certified funds. No monies are generally paid out until after the recording of the loan documents and the deed. All parties concerned are notified of the date and place of the closing. After all documents have been signed, the deed has been transferred, the loan has been recorded, and the monies have been paid, the loan process is completed.

Required Lender Notices

Sections 1098 and 1100A of the Dodd-Frank Act directed the CFPB to publish rules and forms that would combine the disclosures that consumers receive in connection with applying for and closing on a mortgage loan under the Truth in Lending Act (Regulation Z) and the Real Estate Settlement Procedures Act (Regulation X). Consistent with this act, the CFPB amended Regulations X and Z to establish new disclosure requirements and forms in Regulation Z for most closed-end consumer credit transactions secured by real property. The final rule also provides extensive guidance for lenders regarding compliance with the requirements. The new TILA-RESPA Integrated Disclosure Rule has combined the Good Faith Estimate (GFE) and the initial truth-in-lending disclosure (TIL) into a new form, the **Loan Estimate** (see Appendix L). The new form is designed to provide disclosures helpful to consumers in understanding the key features, costs, and risks of the mortgage loan for which they are applying. The form must be supplied to potential borrowers no later than the third business day after loan application is made.

The second new form is the **Closing Disclosure** (see Appendix M), which is a combination of the HUD-1 Settlement Statement and the truth-in-lending disclosure. This form must be provided to the consumer at least three business days before settlement. The

new forms are mandated for use as of August 1, 2015. Prior to that date, the GFE, TIL, and HUD-1 remain in use.

SUMMARY

This chapter described the process of obtaining a real estate loan, including qualifying the borrowers, evaluating the collateral, and determining the status of the property's legal title.

Beginning with an application to secure a loan, the borrowers' credit is analyzed to determine their ability to honor debts and repay the loan as agreed. Current assets and employment are verified and a credit rating is obtained. Other basic criteria used to determine the applicants' creditworthiness include gross monthly earnings adequate to meet the required monthly mortgage payment, stability of earnings, and a good prognosis for continued employment and advancement.

The value of the real estate to be pledged as collateral is analyzed by a certified or licensed appraiser conforming to Appraiser Independence Requirements (AIR). A formal appraisal report is submitted to the loan processor. This estimate of value is derived from the appraiser's application of one or more of the three basic appraisal techniques—the direct sales comparison approach, the cost approach, and the income approach.

The direct sales comparison approach for estimating the value of real property matches the subject property to other, similar properties sold recently to make a value comparison. Because there are no perfect comparables, adjustments must be made to the sales price of those comparables that most closely resemble the subject property. The adjusted sales prices for the comps then indicate the subject property's market value.

The cost approach examines the total worth of a property in terms of the current value of its component parts. The current prices of the bricks, lumber, plumbing fixtures, nails, roofing, electrical fixtures, and so on, are added together to estimate the value of the building if it were to be reproduced as closely as possible to its present condition. If the property is not new, its reproduction cost is depreciated by an appropriate amount. This depreciated value for the improvements, when added to the market value of the lot, establishes an estimate of the total property value.

The income approach measures the value of a property on the basis of the amount and quality of its income stream. An appraiser using the income approach divides the net annual income from the property by a market capitalization rate to derive an estimate of the property's value.

After collecting all data pertinent to the subject property and deriving value estimates by using the various approaches, the appraiser reconciles these estimates and renders an opinion of the property's value. This appraised value is compared to the sales price; the loan is made on the basis of the lower figure.

After a borrower's credit and the collateral's value are verified, the current status of the property's title is examined. The abstract is delivered to the lender's attorney for an opinion of accuracy and validity. Lenders usually require title insurance to guarantee the status of the title.

After the borrower and the collateral are qualified and the title is complete, the loan is ready to be closed. The actual closing may be handled by an attorney, escrow agent, or title company, depending on the part of the country in which the property is located.

INTERNET RESOURCES

American Land Title Association (ALTA)

www.alta.org

American Society of Appraisers (ASA)

www.appraisers.org

Appraisal Institute

www.appraisalinstitute.org

Dun & Bradstreet Credibility Corporation

www.dandb.com

National Association of Independent Fee Appraisers

www.naifa.com

Fair Isaac Corporation

www.myfico.com

REVIEW QUESTIONS

- The first basic procedure usually followed in processing a loan is to
 - determine the borrower's ability to repay the loan.
 - estimate the value of the property to be used as collateral.
 - research the marketability of the title.
 - prepare the documents for closing.
- The average life of a real estate loan is
 - 15 years.
 - 30 years.
 - 7 to 8 years.
 - 10 years.
- A financial statement lists all assets and liabilities of the prospective borrower. A comfortable ratio of assets to liabilities would be
 - 2 to 1.
 - equal.
 - 1 to 1.
 - irrelevant.
- The *MOST* important aspect of a credit report is that it shows
 - the person's attitude toward handling credit and debt.
 - how many accounts the person currently has.
 - what the outstanding balances on accounts are.
 - the number of late payments.
- An appraiser has just completed a search of the records for comparable residential properties that have sold within the last six months. He is using the
 - direct sales comparison approach.
 - cost approach.
 - income approach.
 - gross rent multiplier.
- An appraiser assigned the task of appraising a unique property like a church would probably use the
 - direct sales comparison approach.
 - cost approach.
 - income approach.
 - gross rent multiplier.
- A recorded deed, or recorded note and mortgage, is considered to be
 - actual notice.
 - constructive notice.
 - a title abstract.
 - an opinion of title.
- In which circumstance would an ALTA title insurance policy *NOT* protect both the lender and the new owner?
 - If the signature has been forged
 - If there is an error on the survey
 - If a mechanic's lien is filed a year after settlement
 - If there is an unrecorded easement
- A type of title insurance that includes the state as the guarantor of title is called
 - an ALTA policy.
 - a standard title insurance policy.
 - the Torrens system.
 - an abstract and opinion of title.
- A cloud on the title that is difficult to remove may require that
 - an affidavit of release be signed by the seller.
 - a suit to quiet title be filed.
 - a second opinion on the title search be obtained.
 - the price on the property be raised.

Defaults and Foreclosures

LEARNING OBJECTIVES

When you've finished reading this chapter, you will be able to

- describe the various causes for default on a mortgage loan;
- define the various actions that a lender could take to help the borrower avoid foreclosure;
- differentiate between equitable and statutory redemption periods and how they are used; and
- compare the non-judicial power-of-sale foreclosure with the judicial foreclosure on a mortgage.

deed in lieu of foreclosure

default

deficiency judgment

equitable redemption period

eviction

forbearance

grace period

HOPE NOW

judgment decree

judicial foreclosure

moratorium

power-of-sale method

recast

statutory period of redemption

strict foreclosure

subrogation

upside down or underwater

workouts

The basic responsibilities of the parties to a real estate financial contract are relatively clear-cut. In exchange for money loaned, a borrower is obligated to repay the loan according to conditions stipulated in the contract as well as preserve the value of the collateral and the priority lien position of the lender. In the event the borrower breaches these obligations, the lender can exercise its power of acceleration

and insist that the loan balance, accrued interest, and costs incurred be paid immediately and in full.

In an ideal real estate financing arrangement, a comfortable rhythm of lending and repayment is established between the participants, with few unusual circumstances occurring to cause a breach in the loan agreement. The lender establishes a real estate loan on the basis of availability of funds, general economic conditions, local economic stability, and competitive lenders' actions, as well as the borrower's financial position and the property's value. Unfortunately, the ideal arrangement was sorely misused in the early years of the 21st century, leading to the highest rate of foreclosures ever seen in this country. The government initiated a number of programs administered through the U.S. Treasury and Department of Housing and Development (HUD) in an effort to help millions of struggling homeowners. The Making Home Affordable Program, which included the Home Affordable Modification Program (HAMP) and the Home Affordable Refinancing Program (HARP), was discussed in Chapter 1. One additional program is Home Affordable Foreclosure Alternatives (HAFA), which enabled some homeowners to participate in a short sale or deed in lieu of foreclosure. HAFA was discontinued on December 31, 2013.

HOPE NOW is an alliance of counselors, servicers, investors, and other market participants to maximize outreach efforts to at-risk homeowners. These homeowners are encouraged to call the HOPE Hotline at 888-995-4673 (HOPE) to talk to HUD-approved credit counselors to guide them through possible options such as a loan workout or modification. For more information on government programs, see www.makinghomeaffordable.gov.

Equity Building

Except for infrequent periods in U.S. economic history when severe depressions or recessions created serious financial difficulties (as seen in the economic crisis period starting in 2007), a borrower who pledged realty as security for a loan generally enjoyed the benefits of a steady inflation in the economy that usually increased the value of the property. At the same time, the balance owed on the loan was being paid down. The interaction between this growth in value and the lessening of the loan balance increases the protection against risk for the lender. The slow and steady increase of an equity position encourages the borrower to continue payments on the loan to protect the growing investment. However, when the equity position is eroded and borrowers become upside down or underwater in their mortgages, foreclosure rates begin to climb.

Loan Failure

When a real estate loan fails, it is often the result of events that are beyond the control of the parties to the loan. There are circumstances under which individuals and companies suffer personal or financial setbacks that may jeopardize their ability to maintain normal payment patterns. Some of the more readily recognized problems include loss of employment, illness, divorce, bankruptcy, loss of tenants' rent as a result of local economic setbacks (e.g., overbuilding of income properties), or ordinary mismanagement. Under such

conditions, real estate loan payments usually cannot be met. Defaults and foreclosures result.

The financial crisis beginning in 2007 led to an alarming increase in the number of foreclosures throughout the country. The resetting of subprime loans was largely blamed for many homeowners' inability to make their mortgage payments, though other factors such as the high rate of unemployment were also significant. A report by the Center for Responsible Lending showed a direct link between the higher number of foreclosures and loans originated by brokers such as hybrid-adjustable mortgages, option ARMs, and other subprime loan products.

Realty Trac®, a leading online source for real estate data, released a 2014 Foreclosure Market Report that showed a 23% decrease in the number of foreclosures from the first half of 2013. Daren Blomquist, vice president of RealtyTrac® was quoted in the report as saying, "Nationwide foreclosure activity in June 2014 reached an important milestone, dropping to levels not seen since before the housing price bubble burst in August 2006." He anticipates that foreclosures should return to consistent historic levels within a year.

DEFAULTS

A **default** is the breach of one or more of the conditions or terms of a loan agreement. When a default occurs, the **acceleration clause** contained in all loan contracts is activated, allowing the lender to declare the full amount of the debt immediately due and payable. If the borrower cannot or will not meet this requirement, the lender may 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 seek to avoid foreclosure and arrange a plan with the borrower to protect the interests of both parties and avoid costly, time-consuming court procedures. These efforts are called **workouts** and take the form of payment waivers, refinancing, or other arrangements designed to avoid foreclosure.

Delinquencies

Most loan defaults occur when the borrower falls behind in making payments, in paying taxes, insurance premiums, or other lien payments.

Principal and Interest. The most common form of default occurs when the payment of principal and interest is not made when due, called **delinquency**. Loan agreements stipulate that the regular payment is due "on or before" a specified date, but most lenders will allow a reasonable **grace period**, usually up to 15 days, in which to receive the regular payment. Most loan arrangements include a **late payment charge** of some specific amount that is applied if the borrower exceeds the grace period. 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. Late charges generally range from 3 to 5% of the amount due and may be regulated by state law.

In Practice

A man has made some poor choices on the stock market and now finds himself two months behind on his mortgage payment with no hope of catching up or even being able to continue the regular payment, at least until he is able to sell his house and car.

He is tempted to just lock the door and walk away, but he has always had a good credit rating in the past and believes that this would severely affect his credit score and prevent him from qualifying for future loans. A friend who is a real estate licensee encourages him to discuss his situation with his lender and look for any possible solution other than foreclosure.

The man is pleasantly surprised to learn that the bank is willing to work with him and that the bank, in fact, is not interested in having to foreclose—the lender just wants its money. The man's licensee friend had suggested giving the bank the keys and the deed to the property (in lieu of foreclosure), but the bank does not want to sell the house. Instead, the lender suggests a three-month moratorium where no payment is required. This should give the man time to sell the house and car, giving him the funds to make the loan current. If for some reason this does not work, the bank will consider extending the term of the loan by the extra three months, with the man resuming regular payments at the end of the moratorium period. As a last resort, the bank might consider recasting the loan for a new period of time, resulting in a lower monthly payment.

The important issue here is that the man contacted the lender as soon as he realized he was in trouble. Too often people wait until it really is too late to avoid foreclosure—a no-win situation for both borrower and lender.

Property Taxes. Another cause for default is the nonpayment or late payment of property taxes. Although this situation is not very prevalent with residential loans because of the effectiveness of the impounding technique in which the lender collects funds for taxes and insurance (as described in Chapter 7), it becomes a more serious problem with commercial real estate financing, in which impounds generally are not required.

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 and, thus, is not protected, the collateral property may be sold for taxes, eliminating the safe lien position. 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.

Other Liens. Defaults may also occur when a borrower allows other liens that have priority over the loan to vest against the collateral property. Such liens might be imposed for nonpayment of federal, state, or local income tax. In some jurisdictions, construction and materialmen's (mechanics') liens can take priority over any preexisting liens. Under these circumstances, a lender may consider a loan in default and pursue appropriate legal remedies.

Homeowners Insurance. Another cause for default is the nonpayment of homeowners insurance premiums required by the lender for the protection of the value of the improvements on the collateral property. Again, the impounding technique prevents most of the possible difficulties in this area. However, some realty loan arrangements allow the borrower to pay insurance premiums outside the framework of the regular payment structure, contingent on the mortgagee's prior approval of the insurance carrier and the terms of the policy. Where this independent payment flexibility is granted, 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 paid invoice as evidence of this accomplishment.

The lender is named in the insurance policy as a coinsured along with the borrower/property owner. If any losses are incurred by reason of fire, windstorm, or other insurable circumstance, the lender's collateral position must be preserved. The damages will be repaired to the lender's satisfaction, or the insurance proceeds will be applied to reduce the balance of the loan to match the reduced value of the collateral. Due to several recent natural disasters, such as Hurricanes Katrina and Sandy and numerous earthquakes, obtaining homeowners insurance is no longer a simple transaction. Lenders may require proof of insurance much earlier in the process than they did in previous years.

Poor Property Management

Often lenders include a provision in a formal real estate loan agreement that requires a borrower to maintain the collateral property in such a manner that its value will not diminish to the point of undermining the lender's security position. A breach of this covenant creates a technical default of the terms of the loan. It is difficult to assess the amount of waste that creates such a defaulting situation, especially as its discovery would depend on constant inspection by a lender, an impractical task where many loans are being serviced. Usually, a lender will rely on a borrower's pride of ownership to protect the collateral, but a serious violation can result in a loan default and acceleration of the debt.

ADJUSTMENTS AND MODIFICATIONS

A final foreclosure action is studiously avoided whenever possible. Before a lender decides to foreclose, full consideration is taken of the amount of the borrower's equity in the property, the general state of the current real estate market, and the positions of any junior lienholders. The lender also judiciously weighs the circumstances that caused the default and the attitude of the borrower concerning the repair of the breach in the contract.

The only time a foreclosure should ever be considered is when the current market value of the collateral property is actually less than the balance of the indebtedness and the borrower can no longer make the payment. Even under these extreme circumstances, a borrower should be aware that a foreclosure is not mandatory and that a **deed in lieu of foreclosure** is a possible option if the lender will accept it. A deed in lieu of foreclosure still has a negative impact on the borrower's total credit rating.

The greatest risk to a lender making a real estate loan is that a property pledged as collateral will be abandoned by the borrower. Although this risk is considerably less when

unimproved land is the collateral, any improved property left vacant becomes an immediate and irritating source of concern for a lender.

Frustration may cause a borrower to blindly seek retaliation and perhaps even physically damage the collateral. Even if an abandoned property is left in good condition, a vacant building is often an invitation for vandalism. When investigating their delinquent accounts, many lenders have discovered empty shells of buildings. In the final analysis, many borrowers should be able to negotiate with their lenders from positions of strength rather than weakness. Lenders may be willing to make adjustments to the terms and conditions of the real estate loan contract to reflect emergency needs. Many lenders today are also willing to accept a short sale if they can determine that their loss will be less than it would be from a foreclosure.

Short Sales

As the year 2012 drew to a close, more lenders and homeowners began to view a short sale as a better alternative than letting the home go to foreclosure.

A short sale occurs when a property is sold and there will not be sufficient funds to satisfy the outstanding mortgage lien and other liens secured by the property. The seller must seek agreement from the lender and other lienholders to be released from part of the debt in order to sell the property and convey good title. Generally unheard of in the past, this is now an everyday part of real estate practice. In a short sale, the seller may be referred to as an *upside down* or *underwater seller*.

Moratoriums and Recasting

As discussed earlier, the most common default on real estate loans is delinquent payments.

Most lenders will attempt to cooperate with those borrowers who have legitimate excuses for failing to make payments. Sometimes a lender will waive a portion of the payment, usually the principal amount, to help a delinquent borrower regain financial balance. At other times the interest portion of the payment is waived as well and added to the balance owed toward that time when the borrower regains financial stability. These partial or full payment waivers, described as **forbearance** or **moratoriums**, originated during the Great Depression monetary crises. A lender expects that during the moratorium period the borrower can solve the problem by securing a new job, selling the property to a buyer qualified to make the loan payments, or finding some other acceptable solution.

A forbearance arrangement will usually require that a borrower add extra money to the regular payments when they are reinstated. These extra monies will be applied to satisfy the bubble of principal and interest that accrued during the moratorium.

For a defaulted borrower just recovering sound economic footing, an increase in payments may present too great an additional burden. In order to offset any possible hardships that these extra payments might create, a lender may choose to extend the term of the loan by a time interval equal to the moratorium period. Then the borrower can continue to make regularly scheduled monthly payments at the same amount but for a longer period of time. Another alternative is for the lender to require one balloon payment for all the monies accrued during the moratorium, to be payable at the loan's scheduled expiration date.

Delinquent loans can also be **recast** to lower the payments to suit a borrower's damaged financial position. When a loan has been paid down over a period of time (e.g., five years) and a default is imminent as a result of a borrower's financial crisis, the lender may redesign the balance still owed into a new loan, extending the original time period. This recasting would effectively reduce the payments required and relieve the pressure on the borrower.

Recasting invariably requires a new title search to discover if any intervening liens or second encumbrances have been recorded. This is especially necessary in the case of a delinquent borrower who might have sought aid from other sources. A lender may also require additional collateral and/or cosigners for the new financing agreement.

The government loan modification programs HAMP and HARP (described in Chapter 1) have provided a solution for some lenders and homeowners to resolve the problem without resorting to foreclosure. For some homeowners who are **upside down or underwater** on their mortgage (meaning they owe more than the property is now worth), another option could be a short sale.

A short sale may be the best option if the homeowner does not qualify for either the HAMP or HARP program and there is no hope that the property would sell for enough to pay off the existing debt. Since the lender would be required to accept an amount of money that is less than the amount actually owed, the lender has to give approval for such a sale. Obviously, this would not be the lender's first choice, but many lenders have found their loss would be even greater if they proceed with a foreclosure with multiple carrying costs and no guarantee of a future sale at any price.

The Federal Housing Finance Agency (FHFA) has required both Fannie Mae and Freddie Mac to issue new guidelines to enhance and streamline the short sale process. Eligibility based on hardship has been increased, and improvements have been made to the valuation process for the property.

Voluntary Conveyance of Deed

When all efforts at adjusting the terms of a loan to solve a borrower's problems have failed and the property cannot be sold to a buyer willing and able to assume the loan's balance, a lender may seek to secure a **voluntary transfer of deed** from the borrower. This action prevents the costly and time-consuming process of foreclosure. By executing either a quitclaim deed or a regular deed, a borrower can eliminate the stigma of a foreclosure, maintain a respectable credit rating, and hopefully avoid the possibility of a deficiency judgment. On some applications for a new loan, the borrowers are asked if they have ever executed a voluntary deed in lieu of foreclosure.

A deed in lieu of foreclosure is a mutual agreement in which the delinquent owners of a property deed it to the lender in return for various considerations, usually a release from liability under the terms of the loan. It can be completed quickly, without the cost of a foreclosure, and the rights of third parties having interests in the property are left undisturbed.

However, the lender must take care to be protected against any future claims of fraud or duress by the borrower. Note that some lenders consider a voluntary conveyance of deed as bad as a regular foreclosure with regard to the borrower's credit rating. In times of

financial crisis, as has been the case in the recent decade, banks are very reluctant to accept a deed in lieu. The last thing they want is one more house to have to sell.

FHA and VA Foreclosures

Under the 1964 Housing Act, the FHA required that lenders provide relief in situations in which default is beyond a borrower's control. For example, a lender might recast or extend the mortgage of a borrower who has defaulted because of unemployment during a serious illness. The VA also requires leniency in the case of a borrower who is willing but unable to pay. The VA itself may pay for such delinquencies in order to keep a loan current for a veteran, although these payments do not reduce the debtor's obligation. The VA retains the right to collect these advances at a future date.

AUCTIONS

The use of an **auction** to dispose of foreclosed properties is not a new concept, having been used extensively for years in farm and ranch finance. Originally, an auction was held to determine the true value of a property. Today, however, the major reason for the use of auctions is the pressure of the carrying costs for holding defaulted properties. Auctions often allow them to be sold quickly.

Carrying costs include those for mortgage insurance, maintenance, management, property taxes, and other related expenses. Usually, these costs will not be recouped in the form of a higher selling price. Add to these costs the interest rates in the current market and you can see that holding foreclosed properties creates an enormous burden on lenders.

TYPES OF FORECLOSURES

When all else has failed, a lender pursues foreclosure to recover the collateral in order to sell it and recoup the investment. By definition, to foreclose means to shut out, exclude, bar, or deprive one of the right to redeem a mortgage, deed of trust, or land contract. **Foreclosure**, then, is not only a process to recover a lender's collateral but also a procedure whereby a borrower's rights of redemption are eliminated, and all interests in the subject property are removed.

Under old English law a borrower had few, if any, rights in property beyond possession. If the borrower did not pay on time and in the amount called for, any property rights were immediately forfeited and full ownership was vested in the lender.

This instantaneous and often capricious deprivation of property rights aroused widespread criticism and eventually was brought before the monarch, who assigned the adjudication of these grievances to a court of equity. Certain hardship cases were ruled on according to their merit, rather than on legal technicalities. Gradually, a system developed wherein a distressed borrower was allowed extra time to raise the funds necessary to protect property rights. This relief was called an **equitable redemption period**. Under this ruling, a borrower could secure a certain period beyond the default time in order to

redeem the property. This could be accomplished by either bringing the payments current or repaying the total amount of the principal due in addition to interest owed and any court costs incurred.

As time passed, borrowers began to abuse their equitable redemption rights. Some defaulted borrowers remained in possession of their property beyond the redemption period and otherwise created great difficulties for lenders trying to reclaim the forfeited collateral. Complaints to the court of equity resulted in the decree of foreclosure, a legal process whereby the equitable period of redemption could be terminated under appropriate conditions. This became known as **strict foreclosure** or **strict forfeiture**.

Our present-day redemption and foreclosure processes have evolved from these medieval court decisions. However, during the 1800s, when the U.S. economy was still basically agrarian, many states expanded the strict foreclosure procedure to include additional protection for borrowers' equity interests in anticipation of better harvests in the following year. At the end of the equitable redemption period, the mortgagee was directed to sell the property at public auction rather than automatically take title to the collateral. It was hoped that the foreclosure sale would obtain a fair market value for the property and save part of the borrower's equity. In addition, the defaulted borrower was given another redemption period after the sale to recover the property before title to the collateral was transferred.

This additional time period is called the **statutory period of redemption** because it came into being as a result of the enactment of state statutes. During the entire redemption period, the defaulted borrower is allowed to retain possession of the property. The foreclosure methods and redemption periods vary from state to state.

Judicial Foreclosure and Sale

A common foreclosure procedure, called the **judicial foreclosure** and sale process, involves the use of the courts and the consequent sale of the collateral at public auction. This foreclosure procedure is used in all states where a mortgage is used to establish collateral for a loan. States that use deeds of trust instead of a mortgage to establish collateral for a loan use a nonjudicial process, which is described later in this chapter.

Conventional Mortgages. Before a lender forecloses on a conventional first mortgage, the delinquent mortgagor is notified of the default and the reasons for it. An immediate solution is required, and all efforts must be expended to solve the problem as soon as possible. However, if all attempts fail, a complaint is filed by the mortgagee in the court for the county in which the property is located, and a summons is issued to the mortgagor, initiating the foreclosure action.

Simultaneous with this activity, a title search is made to determine the identities of all parties having an interest in the collateral property, and a **lis pendens** is filed with the court, giving notice to the world of the pending foreclosure action. Notice is sent to all parties having an interest in the property, requesting that they appear to defend their interests, or else they will be foreclosed from any future rights by judgment of the court. It is vitally important for the complainant/mortgagee to notify all junior lienholders of the foreclosure action lest they be omitted from participation in the property auction and, thus, acquire the right to file suit on their own at some future time.

Depending on the number of days required by the jurisdiction for public notice to inform any and all persons having an unrecorded interest in the subject property that a foreclosure suit is imminent, and depending on the availability of a court date, the complaint is eventually aired before a presiding judge. In most instances, the defendant/mortgagor does not appear in court unless special circumstances are presented in defense of the default. Those creditors who do appear to present their claims are recognized and noted, and a sale of the property at public auction by a court-appointed referee or sheriff is ordered by means of a **judgment decree**.

A public sale is necessary in order to establish the actual market value of the subject property. Essentially, the lender sues for foreclosure under the terms of the mortgage. The auction does not usually generate any bids in excess of the balance of the mortgage debt. If the proceeds from the auction sale are not sufficient to recover the outstanding loan balance plus costs, in most states the mortgagee may alternatively sue on the note for the deficiency. Most lenders do not pursue the deficiency, however, because of the apparent financial straits of the defaulted mortgagor. The mortgagee makes the opening bid at the auction in an amount equal to the loan balance plus interest to date and court costs, and then the lender hopes that someone else will bid at least one dollar more. If there are any junior lienholders or other creditors who look to the property as collateral for their loans, they now have the opportunity to step in and bid to protect their priority positions. Their bids obligate them to repay the first mortgagee. When no junior lienholders or creditors enter a bid, the auction closes at the first mortgagee's bid price. Any interests that these junior creditors may have in the property are effectively eliminated. However, if any other person bids an amount above the first mortgage, after the first lien is paid, the excess funds are distributed to the junior lienholders in order of their priority, with any money left over going to the defaulted mortgagor.

Conventional Insured Mortgages. Under the terms of the insurance policies of most private mortgage insurance companies, a default is interpreted to be nonpayment for four months. Within ten days of default, the mortgagee is required to notify the insurer, who then decides whether to instruct the mortgagee to foreclose.

When a conventional insured mortgage is foreclosed, the first mortgagee is the original bidder at the public auction of the collateral property. Under these circumstances, the successful bidder/mortgagee files notice with the insurance company within 60 days after the legal proceedings have transpired. If the insurance company is confident of recovering the losses by purchasing the collateral property from the mortgagee and then reselling it, it will reimburse the mortgagee for the total amount of the bid and secure title to the property. If, however, the company does not foresee any possibility for this recovery, it may elect to only pay the mortgagee the agreed-upon specific amount of insurance, and the mortgagee will retain ownership of the property. The collateral is then sold to recover any balance still unpaid.

In cases of judicial foreclosure and sale, any ownership rights acquired by the successful bidder at the foreclosure auction are still subject to any redemption rights of the defaulted mortgagor. A full fee simple absolute title cannot vest in the bidder until these redemption rights have expired.

FHA-Insured Mortgages. Foreclosures on FHA-insured mortgages originate with the filing of Form 2068, Notice of Default, which must be given to the local FHA administrative office within 60 days of default. This notice describes the reasons for the mortgagor's delinquency, such as death, illness, marital difficulties, income depletion, excessive obligations, employment transfers, or military service.

In many cases involving delinquent FHA-insured mortgages, counselors from the local FHA offices will attempt to design an agreement between the mortgagee and the mortgagor for adjustments to the loan conditions in order to prevent foreclosure. The most common technique used in circumstances where a default is beyond the mortgagor's control but deemed curable is forbearance of foreclosure.

If the problems causing the default are solved within a one-year period, the mortgagee informs the local FHA office of the solution. If not, a default status report is filed, and the mortgagee must initiate foreclosure proceedings. If the bids at the auction are less than the unpaid balance, the mortgagee is expected to bid the debt, take title, and present it to the FHA along with a claim for insurance, which may be paid in cash or in government debentures. In some cases, with prior FHA approval, the mortgagee may assign the defaulted mortgage directly to the FHA before the final foreclosure action in exchange for insurance benefits. In any case, if the property can be sold easily at a price that will repay the loan in full, the mortgagee simply will sell the property after bidding at the auction and will not apply for FHA compensation. If the FHA ends up as the owner of the property, the collateral will be resold "as is" or repaired, refurbished, and resold at a higher price to help minimize the losses to the FHA. Public notice of HUD-owned properties for sale is made through local newspapers and online.

VA-Guaranteed Mortgages. Unlike the FHA-insured mortgages, whereby a lender's entire risk is recovered from the insurance benefits, a VA loan is similar to a privately insured loan in that a lender receives only the top portion of the outstanding loan balance. In the event of a delinquency of more than three months on a VA loan, the mortgagee must file proper notification with the local VA office, which may then elect to bring the loan current if it wishes, with **subrogation** rights to the mortgagee against the mortgagor for the amount advanced. This means that the VA claim against the defaulted veteran takes priority over the rights of the mortgagee to these funds.

Much like the FHA, VA lenders are required to make every effort to offset a foreclosure through forbearance, payment adjustments, sale of the property, deed in lieu of foreclosure, or other acceptable solutions. Actual foreclosure is considered only as a last resort.

In the event of a foreclosure, the mortgagee is usually the original bidder at the auction and submits a claim for losses to the local VA office. The VA then has the option either to pay the unpaid balance, interest, and court costs and take title to the collateral or to require that the mortgagee retain the property and the VA will pay only the difference between the determined value of the property on the date of foreclosure and the mortgage balance. The latter alternative is usually chosen when the property is badly deteriorated, accenting the importance for a mortgagee to properly supervise the collateral.

Junior Mortgages. Defaults of junior mortgages are handled in exactly the same manner as senior mortgages. Here, however, the relationship is usually between two individuals rather than between an institutional lender and an individual borrower.

A junior lender usually seeks the counsel of an attorney to manage the foreclosure process. The delinquent borrower is requested to cure the problem within a certain time period. If a cure cannot be accomplished, notice is given to all persons having an interest in the property, and the attorney then files for foreclosure.

The junior lender is generally the bidder at the public sale and secures ownership of the collateral property subject to the balance of the existing senior loan. This loan is usually required to be paid in full because the foreclosure triggers the due-on-sale clause, unless other solutions are negotiated ahead of time.

Nonjudicial Foreclosure and Sale

An alternative to the judicial foreclosure process is the **power-of-sale method** of collateral recovery. Under this form, a lender or the trustee has the right to sell the collateral property upon default without being required to spend the time and money involved in a court foreclosure suit. In fact, under this form of lender control, a borrower's redemption time frame is shortened considerably by the elimination of the statutory redemption period granted in the judicial process.

Deeds of Trust. The most common application of the power-of-sale foreclosure process is by exercise of the trustee's responsibility created in a deed of trust. In the event of a default, the beneficiary (lender) notifies the trustee in writing of the trustor's (borrower's) delinquency and instructs the trustee to begin the foreclosure by sale process.

Notice of default is recorded by the trustee at the county recorder's office within the jurisdiction's designated time period, usually 90 days, to give notice to the public of the intended auction. This official notice is accompanied by advertisements in public newspapers that state the total amount due and the date of the public sale. Unlike the notice given in the judicial process, notice need not be given to each individual junior lienholder when the power-of-sale process is enforced. However, the trustor/borrowers must be given special notice of the situation so they have full benefit of the redemption period.

During the equitable redemption period preceding the auction, the trustors or any junior lienholders may cure the default by making up any delinquent payments together with interest and costs to date. However, if such payments are not made, the property is placed for sale at public auction shortly after the expiration of the redemption period, and absolute title passes to the successful bidder.

Mortgage. The power-of-sale foreclosure process may be incorporated into the standard mortgage contract in approximately one-third of the states where the trust deed is not in use.

The procedure for foreclosing a mortgage under a power of sale is essentially the same as the one used to foreclose a deed of trust, except that in most states allowing this foreclosure format, the mortgagee is prohibited from bidding at the sale. In addition, the amount that the mortgagee may recover by suing for a deficiency judgment on the note

is limited. The purchaser at a mortgagee's sale acquires the same type of title that would be acquired at a judicial auction and steps into the mortgagor's interest in the property.

Strict Foreclosure

Although judicial and nonjudicial foreclosure procedures are the prevailing practices, in some states (Connecticut, New Hampshire, and Vermont) it is still possible for a lender to recover the collateral through a strict foreclosure process. After appropriate notice has been given to the delinquent borrower and the proper papers have been filed and processed, the court establishes a specific time period during which the balance of the defaulted debt must be paid in full by the borrower. If this is not done, the borrower's equitable and statutory redemption rights are eliminated, and full legal title is awarded to the lender.

Using strict foreclosure, it is possible for a lender to secure ownership to a property with a value in excess of the loan's balance. Because of the possible inequities that might arise from the foreclosure of a property when no value is established, the strict foreclosure method is seldom used and, in fact, has been abolished by statute in some states.

The only effective surviving use of the strict foreclosure method still allowed in many states is under the contract for deed form of financing. By wording a land contract appropriately and carefully observing and following all of the legal steps required for adequate notice to the errant vendee and to the public, a vendor may exercise a strict foreclosure in certain low-equity loan arrangements.

Other Foreclosure Processes

As with a number of laws concerning real estate, many states have established their own unique methods for foreclosing on defaulted mortgages, most of which are variations of the strict foreclosure procedure. Although a legal process in certain states, they usually only occur as a backup plan to the more traditional judicial or nonjudicial foreclosure processes.

By Advertisement. Foreclosure by advertisement is a method whereby a mortgagee notifies the mortgagor of default and advertises that the property will be sold at public auction. The successful purchaser at the auction is awarded an ownership certificate rather than legal possession of the property. To gain possession of the newly acquired property, in most states recognizing this foreclosure process, the successful bidder has to bring an action for **eviction**, which legally dispossesses a defaulted borrower from the premises after a court hearing. The extra cost and trouble associated with this foreclosure procedure keep it from being a popular form for recovering a mortgagee's collateral.

By Entry and Possession. Maine, Massachusetts, New Hampshire, and Rhode Island recognize the power of a mortgagee to petition the court for the right to take actual physical possession of the collateral pledged on a defaulted loan. The entry for possession must be peaceable, made before witnesses, and attested to by a certificate filed with the court. Full legal ownership vests in the mortgagee after a period of time during which the mortgagor may redeem the property by repaying the mortgage lien plus costs. Entry by Possession may be paired with a Power of Sale, allowing the lender to sell the house at a trustee sale.

By Writ of Entry. Maine, Massachusetts, and New Hampshire also allow a mortgagee to initiate a court action whereby a writ of *entry only* is granted. The writ specifies the delinquent amounts due from the mortgagor and the time in which such funds must be paid. If the debt is not paid in accordance with these requirements, the mortgagee receives full legal title to the property. A summary of foreclosure processes is shown in Figure 10.1.

FIGURE 10.1 Summary of the Foreclosure Process

<i>Judicial</i>	<i>Power of Sale</i>	<i>Strict Foreclosure</i>
Notice	Notice	Notice
Lis pendens	Publication	Redemption period
Hearing	Public sale	Repossession
Decree	No redemption	
Public sale		
Redemption period		
<i>By Advertisement</i>	<i>Entry and Possession</i>	<i>Writ of Entry</i>
Notification	Court petition	Court petition
Public sale	Repossession	Eviction
Ownership certificate	Eviction	
Eviction		

DEFICIENCY JUDGMENTS

If a lender receives less money than the entire loan balance, interest to date, and costs incurred as a consequence of a default after the delinquency, default, and foreclosure processes have been completed, the lender may pursue the borrower for these losses. The lender sues on the note and secures a **deficiency judgment** from the court, including an unsecured blanket lien, which may be perfected against any property currently owned or acquired in the future by the foreclosed borrower or any other signatories to the note. As mentioned previously, in most cases a defaulted borrower does not have any assets to make up this deficiency; therefore, deficiency judgments are practically unenforceable.

No deficiency judgments are allowed by the FHA, and while it is possible to obtain a deficiency judgment under a VA-guaranteed loan, the VA discourages this practice. In general, there is little evidence that deficiency judgments are feasible as a means for recovering a lender's losses, and many states have totally eliminated them.

TAX IMPACTS OF FORECLOSURE

In a foreclosure, there may be an unexpected tax consequence for the person or entity that has borrowed the money. In the normal course of events, paying off a real estate loan has

no tax consequences. When the last payment is made, all principal borrowed has been returned, plus interest. However, in a foreclosure, the loan is retired without being paid in full.

A tax is due when the property's adjusted book value is less than the balance of the loan. As far as the IRS is concerned, a foreclosure is considered a sale; if the amount of the defaulted loan exceeds the tax basis of the property, the IRS considers that a gain has been made.

The **Mortgage Forgiveness Debt Relief Act of 2007** allowed taxpayers to file a Form 982 with their tax returns through 2012, which excluded any canceled debt that was forgiven or canceled by a lender as part of a modification of the mortgage or foreclosure on a principal residence. The act was extended through 2013 but remains in legislative limbo in 2014. Concern over whether it will continue has led to a slight drop in short sales throughout the country. More information on obtaining and filling out the form is available at www.irs.gov.

SUMMARY

This chapter summarized the consequences of defaults in real estate finance. Generally, most realty financing arrangements do not result in problems leading to foreclosure. Rising property values coupled with the systematic repayment of loans create measurable equity positions for the borrower that usually inhibit the loss of property because of loan default. However, when the overall housing market began to decline in 2007, the options for an at-risk borrower became very limited. The government initiated numerous loan modification programs as homeowners struggled to make their monthly mortgage payments and the rate of foreclosure began to climb.

Under less dramatic circumstances, a lender usually attempts to adjust the conditions of a loan in order to help a troubled borrower over short-term difficulties. Delinquent loan payments are the most common cause for a default, although the nonpayment of taxes or homeowners insurance premiums, lack of adequate maintenance, and allowing priority liens to vest are also defaultable conditions. To offset the possibility of a foreclosure on delinquent loans, lenders have several workout options, including forbearance or a moratorium on the full payments. Other adjustments in the terms of a delinquent loan that might aid the defaulted borrower include an extension of time or a recasting of the loan to reflect the borrower's current ability to pay. Short sales have become a popular alternative to foreclosure.

A loan is foreclosed only if there are no alternatives. Under a judicial foreclosure proceeding, the lender notifies the defaulting borrower and arranges the advertisement necessary to inform the public that the foreclosure is in process so that all creditors having an interest may be alerted. At the foreclosure sale, the lender usually bids the outstanding balance, hoping that someone will bid one dollar more and repay the loan. When the defaulted mortgage is a conventional loan, the lender assumes the risks of ownership and attempts to sell the property to minimize losses. When the defaulted loan is FHA-insured, the lender recovers any balance owed from the FHA insurance benefits. When the loan is VA-guaranteed or privately insured, the lender will recover the top portion of the loan up to the insured amount and will sell the property to recover the balance.

The foreclosure process is designed to eliminate a borrower's rights in the collateral property. However, the laws of redemption grant the delinquent borrower certain specified times during which the property may be redeemed. Not until the redemption periods expire does the new buyer of the property receive title to it.

A junior lender follows essentially the same procedures in foreclosing a delinquent loan, except that the integrity of the existing senior lender's priority position must be maintained by seeing that the first-mortgage payments, property taxes, and insurance premiums are paid.

Some mortgages and all deeds of trust contain a power-of-sale provision that allows a lender to pursue a somewhat faster foreclosure process than under the judicial process. Under a power of sale, a trustee is entitled to sell a defaulted collateral property with reduced redemption times allotted to the borrower. This nonjudicial foreclosure tool must follow definitive notification and advertisement procedures to be legally valid.

Strict foreclosure proceedings are used only rarely, mostly with contracts for deed. In fact, many states have declared this foreclosure process illegal in their jurisdictions. In effect, the strict foreclosure process quickly eliminates a defaulted borrower's total redemption rights in property.

Other unique foreclosure processes are used in a few states. Foreclosure by advertisement, by entry and possession, and by writ of entry are additional means enabling lenders to recover their collateral.

After all the various processes have been exhausted and a lender sells the collateral, but does not accumulate funds in an amount adequate to cover the investment and costs, the borrower may be sued under the note, and the lender can secure a deficiency judgment for the amount of the loss. Some states have eliminated or reduced the impact of a deficiency judgment. Often it is a practical impossibility to actually secure these funds, and in the event of a foreclosure, most lenders will look to the sale of the collateral property as their ultimate security.

INTERNET RESOURCES

Center for Responsible Lending (CRL)

www.responsiblelending.org

Department of Housing and Urban Development (HUD)

www.hud.gov

Internal Revenue Service (IRS)

www.irs.gov

Mortgage Bankers Association®

www.mbaa.org

RealtyTrac®

www.realtytrac.com

REVIEW QUESTIONS

1. The slow but steady increase in the equity position on mortgaged property is a benefit to
 - a. the borrower.
 - b. the lender.
 - c. both borrower and lender.
 - d. neither borrower nor lender.
2. When a breach in one of the terms or conditions of a loan agreement results in a default, which clause in the contract is activated?
 - a. Alienation
 - b. Acceleration
 - c. Defeasance
 - d. Subordination
3. When a lender agrees to waive a portion or all of the monthly payment for a specified period of time, this is called a
 - a. grace period.
 - b. forbearance or moratorium.
 - c. deed in lieu of foreclosure.
 - d. recasting of the loan.
4. An early English court of equity established an equitable redemption period that allowed for the
 - a. lender to immediately take possession of property on a defaulted loan.
 - b. borrower to have a specified amount of time to clear the default.
 - c. lender to sell the property.
 - d. borrower to remain in the property after it was sold.
5. A mortgage company recognizes there is little point in attempting to sue a homeowner for a deficiency judgment due to his extreme financial difficulties. The mortgage company will therefore
 - a. sue on the note.
 - b. sue on the terms of the mortgage.
 - c. not bid at the auction.
 - d. bid slightly less than the balance due.
6. The *MOST* common technique used in delinquent FHA mortgages where it is determined that the default was caused by circumstances beyond the borrower's control is
 - a. forbearance of foreclosure for a one-year period.
 - b. recasting of the loan.
 - c. moratorium on payments for one year.
 - d. immediate assignment of the loan to the FHA.
7. In the case of a VA loan that goes to foreclosure, the lender receives
 - a. the full amount of the balance due.
 - b. the amount of the entitlement at the present time.
 - c. the top portion of the loan.
 - d. immediate title to the property.
8. The biggest benefit to a lender using the power-of-sale method to foreclose on a property is that it
 - a. guarantees repayment of the loan.
 - b. lengthens the statutory redemption period.
 - c. does not require judicial (court) procedure.
 - d. does not require notice to the public.
9. In strict foreclosure, the court sets a specific time period for the borrower to pay the balance due or else the lender receives full legal title to the property. This usually is found today in which type of real estate financing?
 - a. Note and mortgage
 - b. Note and deed of trust
 - c. Contract for deed
 - d. Deed in lieu
10. The only instance in which there would be a tax consequence to a foreclosure is when the
 - a. amount of the defaulted loan is less than the tax basis on the property.
 - b. amount of the defaulted loan exceeds the tax basis on the property.
 - c. proceeds of the auction pay off the balance due on the loan.
 - d. proceeds of the auction are insufficient to pay off the balance due.

Appendix A: Good Faith Estimate (GFE)



OMB Approval No. 2502-0265

Good Faith Estimate (GFE)

Name of Originator	Borrower
Originator Address	Property Address
Originator Phone Number	Date of GFE
Originator Email	

Purpose

This GFE gives you an estimate of your settlement charges and loan terms if you are approved for this loan. For more information, see HUD's *Special Information Booklet* on settlement charges, your *Truth-in-Lending Disclosures*, and other consumer information at www.hud.gov/respa. If you decide you would like to proceed with this loan, contact us.

Shopping for your loan

Only you can shop for the best loan for you. Compare this GFE with other loan offers, so you can find the best loan. Use the shopping chart on page 3 to compare all the offers you receive.

Important dates

1. The interest rate for this GFE is available through []. After this time, the interest rate, some of your loan Origination Charges, and the monthly payment shown below can change until you lock your interest rate.
2. This estimate for all other settlement charges is available through [].
3. After you lock your interest rate, you must go to settlement within [] days (your rate lock period) to receive the locked interest rate.
4. You must lock the interest rate at least [] days before settlement.

Summary of your loan

Your initial loan amount is	\$
Your loan term is	_____ years
Your initial interest rate is	_____ %
Your initial monthly amount owed for principal, interest, and any mortgage insurance is	\$ _____ per month
Can your interest rate rise?	<input type="checkbox"/> No <input type="checkbox"/> Yes, it can rise to a maximum of _____ %. The first change will be in _____.
Even if you make payments on time, can your loan balance rise?	<input type="checkbox"/> No <input type="checkbox"/> Yes, it can rise to a maximum of \$ _____.
Even if you make payments on time, can your monthly amount owed for principal, interest, and any mortgage insurance rise?	<input type="checkbox"/> No <input type="checkbox"/> Yes, the first increase can be in _____ and the monthly amount owed can rise to \$ _____. The maximum it can ever rise to is \$ _____.
Does your loan have a prepayment penalty?	<input type="checkbox"/> No <input type="checkbox"/> Yes, your maximum prepayment penalty is \$ _____.
Does your loan have a balloon payment?	<input type="checkbox"/> No <input type="checkbox"/> Yes, you have a balloon payment of \$ _____ due in _____ years.

Escrow account information

Some lenders require an escrow account to hold funds for paying property taxes or other property-related charges in addition to your monthly amount owed of \$ [].

Do we require you to have an escrow account for your loan?

No, you do not have an escrow account. You must pay these charges directly when due.

Yes, you have an escrow account. It may or may not cover all of these charges. Ask us.

Summary of your settlement charges

A	Your Adjusted Origination Charges (See page 2.)	\$
B	Your Charges for All Other Settlement Services (See page 2.)	\$
A + B	Total Estimated Settlement Charges	\$

Understanding your estimated settlement charges

Some of these charges can change at settlement. See the top of page 3 for more information.

Your Adjusted Origination Charges							
1. Our origination charge This charge is for getting this loan for you.							
2. Your credit or charge (points) for the specific interest rate chosen <input type="checkbox"/> The credit or charge for the interest rate of [] % is included in "Our origination charge." (See item 1 above.) <input type="checkbox"/> You receive a credit of \$ [] for this interest rate of [] %. This credit reduces your settlement charges. <input type="checkbox"/> You pay a charge of \$ [] for this interest rate of [] %. This charge (points) increases your total settlement charges. The tradeoff table on page 3 shows that you can change your total settlement charges by choosing a different interest rate for this loan.							
A Your Adjusted Origination Charges	\$						
Your Charges for All Other Settlement Services							
3. Required services that we select These charges are for services we require to complete your settlement. We will choose the providers of these services. <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 60%;">Service</th> <th>Charge</th> </tr> </thead> <tbody> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> </tbody> </table>	Service	Charge					
Service	Charge						
4. Title services and lender's title insurance This charge includes the services of a title or settlement agent, for example, and title insurance to protect the lender, if required.							
5. Owner's title insurance You may purchase an owner's title insurance policy to protect your interest in the property.							
6. Required services that you can shop for These charges are for other services that are required to complete your settlement. We can identify providers of these services or you can shop for them yourself. Our estimates for providing these services are below. <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 60%;">Service</th> <th>Charge</th> </tr> </thead> <tbody> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> </tbody> </table>	Service	Charge					
Service	Charge						
7. Government recording charges These charges are for state and local fees to record your loan and title documents.							
8. Transfer taxes These charges are for state and local fees on mortgages and home sales.							
9. Initial deposit for your escrow account This charge is held in an escrow account to pay future recurring charges on your property and includes <input type="checkbox"/> all property taxes, <input type="checkbox"/> all insurance, and <input type="checkbox"/> other [].							
10. Daily interest charges This charge is for the daily interest on your loan from the day of your settlement until the first day of the next month or the first day of your normal mortgage payment cycle. This amount is \$ [] per day for [] days (if your settlement is []).							
11. Homeowner's insurance This charge is for the insurance you must buy for the property to protect from a loss, such as fire. <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 60%;">Policy</th> <th>Charge</th> </tr> </thead> <tbody> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> </tbody> </table>	Policy	Charge					
Policy	Charge						
B Your Charges for All Other Settlement Services	\$						
A + B Total Estimated Settlement Charges	\$						



Instructions

Understanding which charges can change at settlement

This GFE estimates your settlement charges. At your settlement, you will receive a HUD-1, a form that lists your actual costs. Compare the charges on the HUD-1 with the charges on this GFE. Charges can change if you select your own provider and do not use the companies we identify. (See below for details.)

These charges cannot increase at settlement:	The total of these charges can increase up to 10% at settlement:	These charges can change at settlement:
<ul style="list-style-type: none"> ■ Our origination charge ■ Your credit or charge (points) for the specific interest rate chosen (after you lock in your interest rate) ■ Your adjusted origination charges (after you lock in your interest rate) ■ Transfer taxes 	<ul style="list-style-type: none"> ■ Required services that we select ■ Title services and lender's title insurance (if we select them or you use companies we identify) ■ Owner's title insurance (if you use companies we identify) ■ Required services that you can shop for (if you use companies we identify) ■ Government recording charges 	<ul style="list-style-type: none"> ■ Required services that you can shop for (if you do not use companies we identify) ■ Title services and lender's title insurance (if you do not use companies we identify) ■ Owner's title insurance (if you do not use companies we identify) ■ Initial deposit for your escrow account ■ Daily interest charges ■ Homeowner's insurance

Using the tradeoff table

In this GFE, we offered you this loan with a particular interest rate and estimated settlement charges. However:

- If you want to choose this same loan with **lower settlement charges**, then you will have a **higher interest rate**.
- If you want to choose this same loan with a **lower interest rate**, then you will have **higher settlement charges**.

If you would like to choose an available option, you must ask us for a new GFE.

Loan originators have the option to complete this table. Please ask for additional information if the table is not completed.

	The loan in this GFE	The same loan with lower settlement charges	The same loan with a lower interest rate
Your initial loan amount	\$	\$	\$
Your initial interest rate ¹	%	%	%
Your initial monthly amount owed	\$	\$	\$
Change in the monthly amount owed from this GFE	No change	You will pay \$ more every month	You will pay \$ less every month
Change in the amount you will pay at settlement with this interest rate	No change	Your settlement charges will be reduced by \$	Your settlement charges will increase by \$
How much your total estimated settlement charges will be	\$	\$	\$

¹ For an adjustable rate loan, the comparisons above are for the initial interest rate before adjustments are made.

Using the shopping chart

Use this chart to compare GFEs from different loan originators. Fill in the information by using a different column for each GFE you receive. By comparing loan offers, you can shop for the best loan.

	This loan	Loan 2	Loan 3	Loan 4
Loan originator name				
Initial loan amount				
Loan term				
Initial interest rate				
Initial monthly amount owed				
Rate lock period				
Can interest rate rise?				
Can loan balance rise?				
Can monthly amount owed rise?				
Prepayment penalty?				
Balloon payment?				
Total Estimated Settlement Charges				

If your loan is sold in the future

Some lenders may sell your loan after settlement. Any fees lenders receive in the future cannot change the loan you receive or the charges you paid at settlement.



Appendix B: Settlement Statement (HUD-1)

OMB Approval No. 2502-0265



A. Settlement Statement (HUD-1)

B. Type of Loan							
1. <input type="checkbox"/> FHA	2. <input type="checkbox"/> RHS	3. <input type="checkbox"/> Conv. Unins.	6. File Number:	7. Loan Number:	8. Mortgage Insurance Case Number:		
4. <input type="checkbox"/> VA	5. <input type="checkbox"/> Conv. Ins.						
C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.*)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.							
D. Name & Address of Borrower:			E. Name & Address of Seller:		F. Name & Address of Lender:		
G. Property Location:			H. Settlement Agent:		I. Settlement Date:		
			Place of Settlement:				

J. Summary of Borrower's Transaction	
100. Gross Amount Due from Borrower	
101. Contract sales price	
102. Personal property	
103. Settlement charges to borrower (line 1400)	
104.	
105.	
Adjustment for items paid by seller in advance	
106. City/town taxes	to
107. County taxes	to
108. Assessments	to
109.	
110.	
111.	
112.	
120. Gross Amount Due from Borrower	
200. Amount Paid by or in Behalf of Borrower	
201. Deposit or earnest money	
202. Principal amount of new loan(s)	
203. Existing loan(s) taken subject to	
204.	
205.	
206.	
207.	
208.	
209.	
Adjustments for items unpaid by seller	
210. City/town taxes	to
211. County taxes	to
212. Assessments	to
213.	
214.	
215.	
216.	
217.	
218.	
219.	
220. Total Paid by/for Borrower	
300. Cash at Settlement from/to Borrower	
301. Gross amount due from borrower (line 120)	
302. Less amounts paid by/for borrower (line 220)	()
303. Cash	<input type="checkbox"/> From <input type="checkbox"/> To Borrower

K. Summary of Seller's Transaction	
400. Gross Amount Due to Seller	
401. Contract sales price	
402. Personal property	
403.	
404.	
405.	
Adjustment for items paid by seller in advance	
406. City/town taxes	to
407. County taxes	to
408. Assessments	to
409.	
410.	
411.	
412.	
420. Gross Amount Due to Seller	
500. Reductions In Amount Due to seller	
501. Excess deposit (see instructions)	
502. Settlement charges to seller (line 1400)	
503. Existing loan(s) taken subject to	
504. Payoff of first mortgage loan	
505. Payoff of second mortgage loan	
506.	
507.	
508.	
509.	
Adjustments for items unpaid by seller	
510. City/town taxes	to
511. County taxes	to
512. Assessments	to
513.	
514.	
515.	
516.	
517.	
518.	
519.	
520. Total Reduction Amount Due Seller	
600. Cash at Settlement to/from Seller	
601. Gross amount due to seller (line 420)	
602. Less reductions in amounts due seller (line 520)	()
603. Cash	<input type="checkbox"/> To <input type="checkbox"/> From Seller

The Public Reporting Burden for this collection of information is estimated at 35 minutes per response for collecting, reviewing, and reporting the data. This agency may not collect this information, and you are not required to complete this form, unless it displays a currently valid OMB control number. No confidentiality is assured; this disclosure is mandatory. This is designed to provide the parties to a RESPA covered transaction with information during the settlement process.

L. Settlement Charges					
700. Total Real Estate Broker Fees					
Division of commission (line 700) as follows :				Paid From Borrower's Funds at Settlement	Paid From Seller's Funds at Settlement
701. \$	to				
702. \$	to				
703. Commission paid at settlement					
704.					
800. Items Payable in Connection with Loan					
801. Our origination charge		\$	(from GFE #1)		
802. Your credit or charge (points) for the specific interest rate chosen		\$	(from GFE #2)		
803. Your adjusted origination charges				(from GFE #A)	
804. Appraisal fee to				(from GFE #3)	
805. Credit report to				(from GFE #3)	
806. Tax service to				(from GFE #3)	
807. Flood certification to				(from GFE #3)	
808.					
809.					
810.					
811.					
900. Items Required by Lender to be Paid in Advance					
901. Daily interest charges from	to	@ \$	/day	(from GFE #10)	
902. Mortgage insurance premium for months to				(from GFE #3)	
903. Homeowner's insurance for years to				(from GFE #11)	
904.					
1000. Reserves Deposited with Lender					
1001. Initial deposit for your escrow account				(from GFE #9)	
1002. Homeowner's insurance	months @ \$	per month \$			
1003. Mortgage insurance	months @ \$	per month \$			
1004. Property Taxes	months @ \$	per month \$			
1005.	months @ \$	per month \$			
1006.	months @ \$	per month \$			
1007. Aggregate Adjustment				-\$	
1100. Title Charges					
1101. Title services and lender's title insurance				(from GFE #4)	
1102. Settlement or closing fee				\$	
1103. Owner's title insurance				(from GFE #5)	
1104. Lender's title insurance				\$	
1105. Lender's title policy limit \$					
1106. Owner's title policy limit \$					
1107. Agent's portion of the total title insurance premium to				\$	
1108. Underwriter's portion of the total title insurance premium to				\$	
1109.					
1110.					
1111.					
1200. Government Recording and Transfer Charges					
1201. Government recording charges				(from GFE #7)	
1202. Deed \$	Mortgage \$	Release \$			
1203. Transfer taxes				(from GFE #8)	
1204. City/County tax/stamps	Deed \$	Mortgage \$			
1205. State tax/stamps	Deed \$	Mortgage \$			
1206.					
1300. Additional Settlement Charges					
1301. Required services that you can shop for				(from GFE #6)	
1302.				\$	
1303.				\$	
1304.					
1305.					
1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)					

Appendix C: Promissory Note Secured by Deed of Trust

Having reviewed, accepted, and approved this Note with all its terms and conditions, this Note shall supercede any and all other agreements, and is hereby accepted in its final form.

ACCEPTED AND APPROVED:

Maker (Payor)

Maker (Payor)

Holder (Payee)

Holder (Payee)

DO NOT DESTROY THIS NOTE

Do Not Destroy this original Note: When paid, this original note, together with the Deed of Trust securing same must be surrendered to Trustee for Cancellation and retention before reconveyance will be made.

Appendix D: Note & Deed of Trust Purchase Agreement

THIS IS A SAMPLE DOCUMENT ONLY AND IS NOT INTENDED FOR USE.

Disclaimer. We are not attorneys and not licensed to advise you on the law or prepare legal forms for you. Please have an attorney or title company (if applicable) prepare important legal documents.

NOTE & DEED OF TRUST

PURCHASE AGREEMENT

(Without Recourse)

_____, 20__

(1) **DESCRIPTION.** The undersigned Purchaser, and/or assigns, hereby agrees to purchase, and the undersigned Seller hereby agrees to sell and assign, without recourse as to the future financial performance of the Grantor(s), that certain Note and Deed of Trust described as follows:

Date of Note: _____, 20__

Payor:

Payee:

Original Principal Amount: \$ _____

Current Balance: \$ _____

Interest Rate: _____%

Amortization Period:

Balloon:

Balloon Date: _____, 20__

Balloon Amount: \$ _____

Monthly Payments:

Payment Amount: \$ _____

Due Date of Payments:

1st Payment Made: __, 20

Last Payment Made: __, 20

Next Payment Due: __, 20

Number of Payments Made:

Payments Remaining:

Date of Deed of Trust: _____, 20

Recording Date of Trust Deed: __, 20

Place of Recording:

Book & Page: BK_PG(S)

Type of Real Estate:

Address of Real Estate:

Legal Description of

Real Estate: See Attached Exhibit "A"

The Seller warrants and represents that all of the above information is true and correct. The security interest described above shall also be assigned to the Purchaser herein.

(2) **PRICE AND FINANCING.** The purchase price for the above-described Note and Deed of Trust shall be: \$__, payable as follows:_. This Agreement is contingent upon Purchaser obtaining financing to purchase the Seller's interest in the aforesaid Note and Deed of Trust, upon financing terms satisfactory to Purchaser.

(3) **INTERIM PAYMENT RECEIPTS.** Seller shall keep any payments that are received during the pendency of this Agreement; however, any such payments shall be deducted from Seller's proceeds at time of closing.

(4) **REQUIRED DOCUMENTATION.** Seller agrees to provide to Purchaser, within 10 (ten) days of the date of this Agreement, the following "checked" (X) documents:

(X) Copy of Original Note

(X) Copy of Original Recorded Deed of Trust

(X) Amortization Table

(X) Title Policy (ALTA Loan Policy Commitment)*

(X) Copy of Hazard Insurance Policy

(X) Credit Report on Payor of Note*

(or Credit Report Authorization)

(X) Payment History (Affidavit Form)*

(X) Copy of all Underlying Notes, Deed of Trusts, and/or other Liens, along with payoff amounts for each

(X) Appraisal of Real Estate*

(X) Copy of Original Closing Statement

(X) Executed Grantor Estoppel Affidavit*

(X) Executed Beneficiary Estoppel Affidavit*

(X) Picture of Real Estate

(X) Corporate/Partnership Resolution, if applicable

()

()

* Purchaser to obtain or prepare

Seller agrees to provide original Note, Deed of Trust and Closing Statement at closing.

(5) **REVIEW AND INSPECTION CONTINGENCY.** This Agreement is contingent, at the exclusive option of Purchaser only, upon the receipt and satisfactory review of the above-checked items and upon a physical inspection of the real estate securing the aforesaid Note and Deed of Trust.

(6) **CLOSING.** The parties agree that the Closing for the transaction contemplated herein shall occur on or before 15 (fifteen) business days after receipt of all of the above-checked items and completion of the physical inspection of the real estate. The Closing shall be held at a title company of the Purchaser's choosing located in or near the County of , State of , or at such other place as may be designated by the parties hereto.

(7) **COSTS.** The Purchaser shall be responsible for all costs of Closing, including but not limited to: credit report fees, appraisal fees, attorney fees (exclusive of attorney fees incurred by Seller on his own behalf), title examination, title insurance and binder/commitment fees, and any other costs incident to the Closing of the transaction contemplated herein; provided, however, in the event that the property does not appraise at a fair market value of at least \$_, and/or in the event that the title examination discloses any defects or other liens or encumbrances not previously disclosed in writing to the Purchaser, then the Seller shall reimburse Purchaser for all costs incurred pursuant to this Agreement. To ensure Seller's performance hereunder, Seller shall deposit a "Commitment Application Fee" of \$ 350.00 with Purchaser, said fee to be refunded in full to Seller upon the successful closing of the transaction specified in this Agreement; otherwise said fee shall be retained by Purchaser and applied toward the costs which Purchaser may have incurred hereunder.

(8) **SECURITY INTEREST.** To secure Purchaser's interest in and under this Agreement, Seller hereby grants a security interest in the Deed of Trust and Note described in paragraph (1) of this Agreement; Seller further agrees to execute any and all documents now or hereafter required to fully perfect Purchaser's security interest and/or to fully consummate the transaction contemplated herein.

(9) **CANCELLATION FEE.** Should the Seller wish to cancel this Agreement prior to Closing, Seller paying to the Purchaser by means of a certified check, cashier's check or money order, an amount equal to 5% of the current balance due on the Note as specified in Paragraph (1) herein, plus any costs incurred or advanced by Purchaser, including earnest monies. Upon receipt of said sum by Purchaser, all rights and interest in and under this Agreement shall be extinguished forever, and Seller and Purchaser shall both be released of any and all obligations or liabilities hereunder.

(10) **DEFAULT.** Should Seller default under this Agreement, Seller shall be liable to Purchaser for all expenses, damages, losses, attorneys fees, and other costs which Purchaser may incur, in addition to the cancellation fee stated in paragraph (9).

(11) **SELLER'S REPRESENTATIONS AND WARRANTIES.** The Seller hereby covenants, represents and warrants as follows:

(a) That the Deed of Trust is a good and valid instrument and constitutes a valid lien against the real property described therein.

(b) That the Seller is vested with a full and absolute title to said Deed of Trust and Note and has authority to assign and transfer the same which are presently free and clear of all encumbrances, except:.

(c) That the real property secured by the Deed of Trust has a fair market value of at least \$.

(d) That the original principal face amount of the Deed of Trust and Note has been advanced to or on behalf of the Grantor; that the Grantor received consideration for the Note and Deed of Trust; and that there are no defaults existing at the present time under any of the covenants contained in the said Deed of Trust and Note except the following:.

(e) That the Deed of Trust and Note were not originated or closed in a manner which violated, or now violates, any Federal, State or Local laws, ordinances, regulations or rulings including, without limitation, Federal and State truth-in-lending laws and any other consumer protection laws, any applicable State usury laws, the requirements of the Real Estate Settlement Procedures Act of 1974, the applicable requirements of the Servicemen's Readjustment Act of 1944, and the National Housing Act.

(f) That there are no undisclosed agreements between the Grantor and the Seller concerning any facts or conditions whether past, present or future which might in any way affect the obligations of the Grantor(s) to make timely payments thereon.

(g) That the Seller has no knowledge of any valid legal defenses which would adversely affect the collectibility or enforceability of the Deed of Trust and/or Note.

(h) That the Deed of Trust and Note documents were executed by person(s) purported to be the Grantor(s) and contain no forged or unauthorized signatures, and that the parties named therein were of full age and capacity to contract.

(i) That the Note and Deed of Trust and any other documents, instruments, or records representing, evidencing, or relating thereto, are true, correct, undisputed,

and reflect full, correct, and accurate information as to the balance and the status thereof; and that no credit heretofore has been given the Grantor(s) which was gratuitous or was given for a payment made by an employee or agent of the Seller, or which has arisen from a renewal granted for the purpose of concealing or restructuring a delinquency.

(j) That the Deed of Trust and Note are free of the claim or defense of usury and free from any set-off, claim, counterclaim, or defense of any nature whatsoever; that no settlement, payment or compromise has been made with respect to the Deed of Trust and Note; and that no special promise or consideration has been made to the Grantor.

(k) That all other information contained within this Agreement is true, correct, and accurate, in all respects.

(13) **INDEMNIFICATION.** Seller agrees to indemnify and save Purchaser harmless from and against any and all loss, damage, liability and expense (including its reasonable attorney's fees and cost of litigation) sustained or incurred by Purchaser arising out of, or based upon, the inaccuracy or breach of any warranty or representation made by Seller or its agent(s) under this Agreement or of any covenant to be performed by Seller under this Agreement.

(14) **SOLE AGREEMENT.** This Agreement sets forth the entire agreement of the parties with respect to the subject matter hereof and it supersedes and cancels any and all prior negotiations, arrangements, agreements, and understandings, whether oral or written between the parties respecting the subject matter hereof. This Agreement shall survive the Closing.

(15) **TIME AND BINDING EFFECT.** Time shall always be of the essence and this Agreement shall inure and be binding upon the respective heirs, representatives, successors and assigns of the parties hereto.

(16) **ASSIGNMENT WITHOUT RECOURSE.** The Seller agrees to sell and assign the said Note and Deed of Trust without recourse as to the future financial performance of the Grantor(s) and assumes no responsibility or liability relating thereto. However, as to all other terms, conditions, representatives, warranties, and covenants of this Agreement, the Seller agrees to assume personal responsibility and liability therefore.

(17) **DISCLAIMER.** The parties hereto acknowledge that the Purchaser is NOT an agent of the Seller; nor does the Purchaser have any fiduciary obligation to the Seller. The Purchaser is acting as an independent investor and/or dealer in this

transaction, with the expectation of profit; the Seller disclaims any representative relationship and disclaims any interest in the Purchaser's profit.

(18) OTHER TERMS, CONDITIONS, OR CONTINGENCIES:

IN WITNESS WHEREOF, this Agreement was executed by the parties hereto on the date first above mentioned.

SIGNED:

BUYER(S):

-

Witness

-

Witness

-

Witness

-

SELLER(S):

-

Witness

-

Witness

-

Witness

Address of Seller(s):

SAMPLE

Phone:

-

Address of Buyer(s):

Phone:

(State of , County of) SS:

Before me, a Notary Public in and for said state and county, personally came , the Buyer in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20.

Notary Public

(Seal)

(Exp. Date)

(State of , County of) SS:

-

Before me, a Notary Public in and for said state and county, personally came , the Buyer in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20 .

(Seal) Notary Public

(Exp. Date)

(State of , County of) SS:

Before me, a Notary Public in and for said state and county, personally came , the Seller in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20 .

(Seal) Notary Public

(Exp. Date)

(State of , County of) SS:

-

Before me, a Notary Public in and for said state and county, personally came , the Seller in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20 .

(Seal) Notary Public

(Exp. Date)

SAMPLE

EXHIBIT A

(Legal Description of Mortgaged Property)

SAMPLE

Appendix E: Note & Mortgage Purchase Agreement

THIS IS A SAMPLE DOCUMENT ONLY AND IS NOT INTENDED FOR USE.

Disclaimer. We are not attorneys and not licensed to advise you on the law or prepare legal forms for you. Please have an attorney or title company (if applicable) prepare important legal documents.

NOTE & MORTGAGE

PURCHASE AGREEMENT

(Without Recourse)

_____, 20__

(1) **DESCRIPTION.** The undersigned Purchaser, and/or assigns, hereby agrees to purchase, and the undersigned Seller hereby agrees to sell and assign, without recourse as to the future financial performance of the mortgagor(s), that certain Note and Mortgage described as follows:

Date of Note: _____, 20__

Payor:

Payee:

Original Principal Amount: \$ _____

Current Balance: \$ _____

Interest Rate: _____%

Amortization Period:

Balloon:

Balloon Date: _____, 20__

Balloon Amount: \$ _____

Monthly Payments:

Payment Amount: \$ _____

Due Date of Payments:

1st Payment Made: __, 20

Last Payment Made: __, 20

Next Payment Due: __, 20

Number of Payments Made:

Payments Remaining:

Date of Mortgage: _____, 20

Recording Date of Mortgage: _____, 20

Place of Recording:

Book & Page: BK_PG(S)

Type of Real Estate:

Address of Real Estate:

Legal Description of

Real Estate: See Attached Exhibit "A"

The Seller warrants and represents that all of the above information is true and correct. The security interest described above shall also be assigned to the Purchaser herein.

(2) **PRICE AND FINANCING.** The purchase price for the above-described Note and Mortgage shall be: \$__, payable as follows:_. This Agreement is contingent upon Purchaser obtaining financing to purchase the Seller's interest in the aforesaid Note and Mortgage, upon financing terms satisfactory to Purchaser.

(3) **INTERIM PAYMENT RECEIPTS.** Seller shall keep any payments that are received during the pendency of this Agreement; however, any such payments shall be deducted from Seller's proceeds at time of closing.

(4) **REQUIRED DOCUMENTATION.** Seller agrees to provide to Purchaser, within 10 (ten) days of the date of this Agreement, the following "checked" (X) documents:

(X) Copy of Original Note

(X) Copy of Original Recorded Mortgage

Amortization Table

Title Policy (ALTA Loan Policy Commitment)*

Copy of Hazard Insurance Policy

Credit Report on Payor of Note*

(or Credit Report Authorization)

Payment History (Affidavit Form)*

Copy of all Underlying Notes, Mortgages, and/or other Liens, along with payoff amounts for each

Appraisal of Real Estate*

Copy of Original Closing Statement

Executed Mortgagor Estoppel Affidavit*

Executed Mortgagee Estoppel Affidavit*

Picture of Real Estate

Corporate/Partnership Resolution, if applicable

* Purchaser to obtain or prepare

Seller agrees to provide original Note, Mortgage and Closing Statement at closing.

(5) REVIEW AND INSPECTION CONTINGENCY. This Agreement is contingent, at the exclusive option of Purchaser only, upon the receipt and satisfactory review of the above-checked items and upon a physical inspection of the real estate securing the aforesaid Note and Mortgage.

(6) **CLOSING.** The parties agree that the Closing for the transaction contemplated herein shall occur on or before 15 (fifteen) business days after receipt of all of the above-checked items and completion of the physical inspection of the real estate. The Closing shall be held at a title company of the Purchaser's choosing located in or near the County of , State of , or at such other place as may be designated by the parties hereto.

(7) **COSTS.** The Purchaser shall be responsible for all costs of Closing, including but not limited to: credit report fees, appraisal fees, attorney fees (exclusive of attorney fees incurred by Seller on his own behalf), title examination, title insurance and binder/commitment fees, and any other costs incident to the Closing of the transaction contemplated herein; provided, however, in the event that the property does not appraise at a fair market value of at least \$_, and/or in the event that the title examination discloses any defects or other liens or encumbrances not previously disclosed in writing to the Purchaser, then the Seller shall reimburse Purchaser for all costs incurred pursuant to this Agreement. To ensure Seller's performance hereunder, Seller shall deposit a "Commitment Application Fee" of \$ 350.00 with Purchaser, said fee to be refunded in full to Seller upon the successful closing of the transaction specified in this Agreement; otherwise said fee shall be retained by Purchaser and applied toward the costs which Purchaser may have incurred hereunder.

(8) **SECURITY INTEREST.** To secure Purchaser's interest in and under this Agreement, Seller hereby grants a security interest in the Mortgage and Note described in paragraph (1) of this Agreement; Seller further agrees to execute any and all documents now or hereafter required to fully perfect Purchaser's security interest and/or to fully consummate the transaction contemplated herein.

(9) **CANCELLATION FEE.** Should the Seller wish to cancel this Agreement prior to Closing, Seller paying to the Purchaser by means of a certified check, cashier's check or money order, an amount equal to 5% of the current balance due on the Note as specified in Paragraph (1) herein, plus any costs incurred or advanced by Purchaser, including earnest monies. Upon receipt of said sum by Purchaser, all rights and interest in and under this Agreement shall be extinguished forever, and Seller and Purchaser shall both be released of any and all obligations or liabilities hereunder.

(10) **DEFAULT.** Should Seller default under this Agreement, Seller shall be liable to Purchaser for all expenses, damages, losses, attorneys fees, and other costs which Purchaser may incur, in addition to the cancellation fee stated in paragraph (9).

(11) **SELLER'S REPRESENTATIONS AND WARRANTIES.** The Seller hereby covenants, represents and warrants as follows:

(a) That the Mortgage is a good and valid instrument and constitutes a valid lien against the real property described therein.

(b) That the Seller is vested with a full and absolute title to said Mortgage and Note and has authority to assign and transfer the same which are presently free and clear of all encumbrances, except:.

(c) That the real property secured by the Mortgage has a fair market value of at least \$.

(d) That the original principal face amount of the Mortgage and Note has been advanced to or on behalf of the mortgagor; that the mortgagor received consideration for the Note and Mortgage; and that there are no defaults existing at the present time under any of the covenants contained in the said Mortgage and Note except the following:.

(e) That the Mortgage and Note were not originated or closed in a manner which violated, or now violates, any Federal, State or Local laws, ordinances, regulations or rulings including, without limitation, Federal and State truth-in-lending laws and any other consumer protection laws, any applicable State usury laws, the requirements of the Real Estate Settlement Procedures Act of 1974, the applicable requirements of the Servicemen's Readjustment Act of 1944, and the National Housing Act.

(f) That there are no undisclosed agreements between the mortgagor and the Seller concerning any facts or conditions whether past, present or future which might in any way affect the obligations of the mortgagor(s) to make timely payments thereon.

(g) That the Seller has no knowledge of any valid legal defenses which would adversely affect the collectibility or enforceability of the Mortgage and/or Note.

(h) That the Mortgage and Note documents were executed by person(s) purported to be the mortgagor(s) and contain no forged or unauthorized signatures, and that the parties named therein were of full age and capacity to contract.

(i) That the Note and Mortgage and any other documents, instruments, or records representing, evidencing, or relating thereto, are true, correct, undisputed, and reflect full, correct, and accurate information as to the

balance and the status thereof; and that no credit heretofore has been given the mortgagor(s) which was gratuitous or was given for a payment made by an employee or agent of the Seller, or which has arisen from a renewal granted for the purpose of concealing or restructuring a delinquency.

(j) That the Mortgage and Note are free of the claim or defense of usury and free from any set-off, claim, counterclaim, or defense of any nature whatsoever; that no settlement, payment or compromise has been made with respect to the Mortgage and Note; and that no special promise or consideration has been made to the mortgagor.

(k) That all other information contained within this Agreement is true, correct, and accurate, in all respects.

(13) INDEMNIFICATION. Seller agrees to indemnify and save Purchaser harmless from and against any and all loss, damage, liability and expense (including its reasonable attorney's fees and cost of litigation) sustained or incurred by Purchaser arising out of, or based upon, the inaccuracy or breach of any warranty or representation made by Seller or its agent(s) under this Agreement or of any covenant to be performed by Seller under this Agreement.

(14) SOLE AGREEMENT. This Agreement sets forth the entire agreement of the parties with respect to the subject matter hereof and it supersedes and cancels any and all prior negotiations, arrangements, agreements, and understandings, whether oral or written between the parties respecting the subject matter hereof. This Agreement shall survive the Closing.

(15) TIME AND BINDING EFFECT. Time shall always be of the essence and this Agreement shall inure and be binding upon the respective heirs, representatives, successors and assigns of the parties hereto.

(16) ASSIGNMENT WITHOUT RECOURSE. The Seller agrees to sell and assign the said Note and Mortgage without recourse as to the future financial performance of the mortgagor(s) and assumes no responsibility or liability relating thereto. However, as to all other terms, conditions, representatives, warranties, and covenants of this Agreement, the Seller agrees to assume personal responsibility and liability therefore.

(17) DISCLAIMER. The parties hereto acknowledge that the Purchaser is NOT an agent of the Seller; nor does the Purchaser have any fiduciary obligation to the Seller. The Purchaser is acting as an independent investor and/or dealer in this transaction, with the expectation of profit; the Seller disclaims any representative relationship and disclaims any interest in the Purchaser's profit.

(18) OTHER TERMS, CONDITIONS, OR CONTINGENCIES:

-
-
-
-
-
-
-
-

IN WITNESS WHEREOF, this Agreement was executed by the parties hereto on the date first above mentioned.

SIGNED:

BUYER(S):

-

Witness

-

Witness

-

Witness

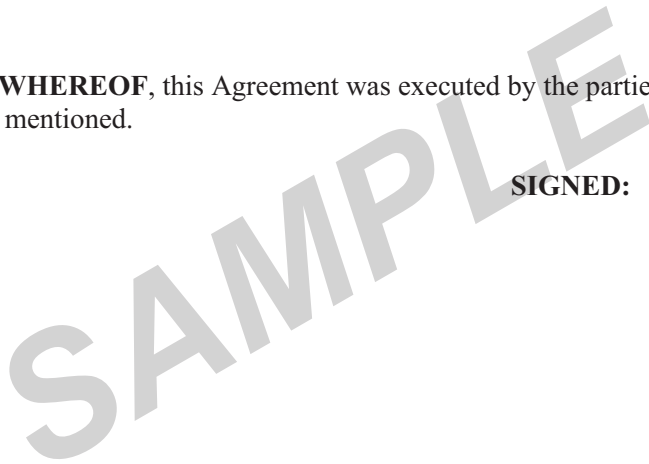
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SELLER(S):

-

Witness

-



Witness

-

Witness

Address of Seller(s):

Phone:

-

Address of Buyer(s):

Phone:

(State of , County of) SS:

Before me, a Notary Public in and for said state and county, personally came , the Buyer in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20.

Notary Public

(Seal)

(Exp. Date)

(State of , County of) SS:

-

Before me, a Notary Public in and for said state and county, personally came , the Buyer in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20 .

(Seal) Notary Public

(Exp. Date)

(State of , County of) SS:

Before me, a Notary Public in and for said state and county, personally came , the Seller in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20 .

(Seal) Notary Public

(Exp. Date)

(State of , County of) SS:

-

Before me, a Notary Public in and for said state and county, personally came , the Seller in the above instrument, who acknowledged the execution of same to be (his, her) free and voluntary act and deed.

In testimony whereof, I have hereunto subscribed my name and affixed my notarial seal at , , on this day of , 20 .

(Seal) Notary Public

(Exp. Date)

EXHIBIT A

(Legal Description of Mortgaged Property)

SAMPLE

Appendix F: Fixed/Adjustable Rate Note

FIXED/ADJUSTABLE RATE NOTE
(LIBOR One-Year Index (As Published In *The Wall Street Journal*)—Rate Caps)

THIS NOTE PROVIDES FOR A CHANGE IN MY FIXED INTEREST RATE TO AN ADJUSTABLE INTEREST RATE. THIS NOTE LIMITS THE AMOUNT MY ADJUSTABLE INTEREST RATE CAN CHANGE AT ANY ONE TIME AND THE MAXIMUM RATE 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 Lender. Lender is _____. I will make all payments under this Note in the form of cash, check or money order.

I understand that Lender may transfer this Note. 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 may 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 payments 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 _____, _____, 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

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. ADJUSTABLE INTEREST RATE AND MONTHLY PAYMENT CHANGES**(A) Change Dates**

The initial fixed interest rate I will pay will change to an adjustable interest rate on the first day of _____, _____, and the adjustable interest rate I will pay may change on that day every 12th month thereafter. The date on which my initial fixed interest rate changes to an adjustable interest rate, and each date on which my adjustable interest rate could change, is called a "Change Date."

(B) The Index

Beginning with the first Change Date, my adjustable 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 figure available as of the date 45 days before each Change Date is called the "Current Index."

If the Index is no longer available, the Note Holder will choose a new index that 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 (_____%) 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 adjustable 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 _____%.

(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 initial fixed interest rate to an adjustable interest rate and of any changes in my adjustable interest rate before the effective date of any change. The notice will include the amount of my monthly payment, any 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 this Note.

I may make a full Prepayment or partial Prepayments without paying any 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 this Note. If I make a partial Prepayment, there will be no changes in the due dates of my monthly payments 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 that 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 that 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.

Unless the Note Holder requires a different method, any notice that must be given to the Note Holder under this Note will be given 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 that might result if I do not keep the promises that 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 read as follows:

(A) Until my initial fixed interest rate changes to an adjustable interest rate under the terms stated in Section 4 above, Uniform Covenant 18 of the Security Instrument shall read as follows:

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.

(B) When my initial fixed interest rate changes to an adjustable interest rate under the terms stated in Section 4 above, Uniform Covenant 18 of the Security Instrument described in Section 11(A) above shall then cease to be in effect, and Uniform Covenant 18 of the Security Instrument shall instead read as follows:

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. 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 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 also may 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]

Appendix G: Uniform Residential Loan Application

Uniform Residential Loan Application

This application is designed to be completed by the applicant(s) with the Lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower," as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when the income or assets of a person other than the Borrower (including the Borrower's spouse) will be used as a basis for loan qualification or the income or assets of the Borrower's spouse or other person who has community property rights pursuant to state law will not be used as a basis for loan qualification, but his or her liabilities must be considered because the spouse or other person has community property rights pursuant to applicable law and Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

If this is an application for joint credit, Borrower and Co-Borrower each agree that we intend to apply for joint credit (sign below):

Borrower		Co-Borrower			
I. TYPE OF MORTGAGE AND TERMS OF LOAN					
Mortgage Applied for: <input type="checkbox"/> VA <input type="checkbox"/> Conventional <input type="checkbox"/> Other (explain):		Agency Case Number			
<input type="checkbox"/> FHA <input type="checkbox"/> USDA/Rural Housing Service		Lender Case Number			
Amount \$	Interest Rate %	No. of Months	Amortization Type: <input type="checkbox"/> Fixed Rate <input type="checkbox"/> Other (explain):		
			<input type="checkbox"/> GPM <input type="checkbox"/> ARM (type):		
II. PROPERTY INFORMATION AND PURPOSE OF LOAN					
Subject Property Address (street, city, state & ZIP)			No. of Units		
Legal Description of Subject Property (attach description if necessary)			Year Built		
Purpose of Loan <input type="checkbox"/> Purchase <input type="checkbox"/> Construction <input type="checkbox"/> Other (explain):		Property will be: <input type="checkbox"/> Primary Residence <input type="checkbox"/> Secondary Residence <input type="checkbox"/> Investment			
<input type="checkbox"/> Refinance <input type="checkbox"/> Construction-Permanent					
<i>Complete this line if construction or construction-permanent loan.</i>					
Year Lot Acquired	Original Cost	Amount Existing Liens	(a) Present Value of Lot		
	\$	\$	\$		
			(b) Cost of Improvements		
			\$		
			Total (a + b)		
			\$		
<i>Complete this line if this is a refinance loan.</i>					
Year Acquired	Original Cost	Amount Existing Liens	Purpose of Refinance		
	\$	\$			
			Describe Improvements		
			<input type="checkbox"/> made <input type="checkbox"/> to be made		
			Cost: \$		
Title will be held in what Name(s)		Manner in which Title will be held			
Source of Down Payment, Settlement Charges, and/or Subordinate Financing (explain)		Estate will be held in: <input type="checkbox"/> Fee Simple <input type="checkbox"/> Leasehold (show expiration date)			
Borrower		III. BORROWER INFORMATION		Co-Borrower	
Borrower's Name (include Jr. or Sr. if applicable)		Co-Borrower's Name (include Jr. or Sr. if applicable)			
Social Security Number	Home Phone (incl. area code)	DOB (mm/dd/yyyy)	Yrs. School	Social Security Number	Home Phone (incl. area code)
<input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed)		Dependents (not listed by Co-Borrower) no. ages		<input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed)	
				Dependents (not listed by Borrower) no. ages	
Present Address (street, city, state, ZIP)		<input type="checkbox"/> Own <input type="checkbox"/> Rent ___ No. Yrs.		Present Address (street, city, state, ZIP)	
				<input type="checkbox"/> Own <input type="checkbox"/> Rent ___ No. Yrs.	
Mailing Address, if different from Present Address				Mailing Address, if different from Present Address	
<i>If residing at present address for less than two years, complete the following:</i>					
Former Address (street, city, state, ZIP)		<input type="checkbox"/> Own <input type="checkbox"/> Rent ___ No. Yrs.		Former Address (street, city, state, ZIP)	
				<input type="checkbox"/> Own <input type="checkbox"/> Rent ___ No. Yrs.	
Borrower		IV. EMPLOYMENT INFORMATION		Co-Borrower	
Name & Address of Employer		<input type="checkbox"/> Self Employed		Name & Address of Employer	
		Yrs. on this job			
		Yrs. employed in this line of work/profession			
Position/Title/Type of Business		Business Phone (incl. area code)		Position/Title/Type of Business	
				Business Phone (incl. area code)	

If employed in current position for less than two years or if currently employed in more than one position, complete the following:

Borrower		IV. EMPLOYMENT INFORMATION (cont'd)		Co-Borrower	
Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)	Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)
		Monthly Income \$			Monthly Income \$
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)
Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)	Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)
		Monthly Income \$			Monthly Income \$
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)

V. MONTHLY INCOME AND COMBINED HOUSING EXPENSE INFORMATION						
Gross Monthly Income	Borrower	Co-Borrower	Total	Combined Monthly Housing Expense	Present	Proposed
Base Empl. Income*	\$	\$	\$	Rent	\$	
Overtime				First Mortgage (P&I)		\$
Bonuses				Other Financing (P&I)		
Commissions				Hazard Insurance		
Dividends/Interest				Real Estate Taxes		
Net Rental Income				Mortgage Insurance		
Other (before completing, see the notice in "describe other income," below)				Homeowner Assn. Dues		
				Other:		
Total	\$	\$	\$	Total	\$	\$

* Self Employed Borrower(s) may be required to provide additional documentation such as tax returns and financial statements.

Describe Other Income

Notice: Alimony, child support, or separate maintenance income need not be revealed if the Borrower (B) or Co-Borrower (C) does not choose to have it considered for repaying this loan.

B/C	Monthly Amount
	\$

VI. ASSETS AND LIABILITIES

This Statement and any applicable supporting schedules may be completed jointly by both married and unmarried Co-Borrowers if their assets and liabilities are sufficiently joined so that the Statement can be meaningfully and fairly presented on a combined basis; otherwise, separate Statements and Schedules are required. If the Co-Borrower section was completed about a non-applicant spouse or other person, this Statement and supporting schedules must be completed about that spouse or other person also.

Completed Jointly Not Jointly

ASSETS	Cash or Market Value	LIABILITIES	Monthly Payment & Months Left to Pay	Unpaid Balance
Description		Liabilities and Pledged Assets. List the creditor's name, address, and account number for all outstanding debts, including automobile loans, revolving charge accounts, real estate loans, alimony, child support, stock pledges, etc. Use continuation sheet, if necessary. Indicate by (*) those liabilities, which will be satisfied upon sale of real estate owned or upon refinancing of the subject property.		
Cash deposit toward purchase held by:	\$	Name and address of Company	\$ Payment/Months	\$
<i>List checking and savings accounts below</i>				
Name and address of Bank, S&L, or Credit Union		Name and address of Company	\$ Payment/Months	\$
Acct. no.	\$	Acct. no.		
Name and address of Bank, S&L, or Credit Union		Name and address of Company	\$ Payment/Months	\$
Acct. no.	\$	Acct. no.		
Name and address of Bank, S&L, or Credit Union		Name and address of Company	\$ Payment/Months	\$
Acct. no.	\$	Acct. no.		

VI. ASSETS AND LIABILITIES (cont'd)					
Name and address of Bank, S&L, or Credit Union		Name and address of Company		\$ Payment/Months	\$
Acct. no.	\$	Acct. no.			
Stocks & Bonds (Company name/ number & description)		Name and address of Company		\$ Payment/Months	\$
		Acct. no.			
Life insurance net cash value		Name and address of Company		\$ Payment/Months	\$
Face amount: \$					
Subtotal Liquid Assets					
Real estate owned (enter market value from schedule of real estate owned)					
Vested interest in retirement fund					
Net worth of business(es) owned (attach financial statement)		Acct. no.			
Automobiles owned (make and year)		Alimony/Child Support/Separate Maintenance Payments Owed to:		\$	
Other Assets (itemize)		Job-Related Expense (child care, union dues, etc.)		\$	
		Total Monthly Payments		\$	
Total Assets a.		Net Worth (a minus b) ▶		\$	Total Liabilities b.
					\$

Schedule of Real Estate Owned (If additional properties are owned, use continuation sheet.)

Property Address (enter S if sold, PS if pending sale or R if rental being held for income)	Type of Property	Present Market Value	Amount of Mortgages & Liens	Gross Rental Income	Mortgage Payments	Insurance, Maintenance, Taxes & Misc.	Net Rental Income
		\$	\$	\$	\$	\$	\$
	Totals	\$	\$	\$	\$	\$	\$

List any additional names under which credit has previously been received and indicate appropriate creditor name(s) and account number(s):

Alternate Name	Creditor Name	Account Number

VII. DETAILS OF TRANSACTION		VIII. DECLARATIONS					
a. Purchase price	\$	If you answer "Yes" to any questions a through i, please use continuation sheet for explanation. a. Are there any outstanding judgments against you? b. Have you been declared bankrupt within the past 7 years? c. Have you had property foreclosed upon or given title or deed in lieu thereof in the last 7 years? d. Are you a party to a lawsuit? e. Have you directly or indirectly been obligated on any loan which resulted in foreclosure, transfer of title in lieu of foreclosure, or judgment? (This would include such loans as home mortgage loans, SBA loans, home improvement loans, educational loans, manufactured (mobile) home loans, any mortgage, financial obligation, bond, or loan guarantee. If "Yes," provide details, including date, name, and address of Lender, FHA or VA case number, if any, and reasons for the action.)		Borrower Yes No		Co-Borrower Yes No	
b. Alterations, improvements, repairs				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
c. Land (if acquired separately)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
d. Refinance (incl. debts to be paid off)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
e. Estimated prepaid items				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
f. Estimated closing costs				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
g. PMI, MIP, Funding Fee				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
h. Discount (if Borrower will pay)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
i. Total costs (add items a through h)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

VII. DETAILS OF TRANSACTION		VIII. DECLARATIONS					
		Borrower		Co-Borrower			
		Yes	No	Yes	No		
j.	Subordinate financing	If you answer "Yes" to any questions a through i, please use continuation sheet for explanation.					
k.	Borrower's closing costs paid by Seller	f.	Are you presently delinquent or in default on any Federal debt or any other loan, mortgage, financial obligation, bond, or loan guarantee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
		g.	Are you obligated to pay alimony, child support, or separate maintenance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
l.	Other Credits (explain)	h.	Is any part of the down payment borrowed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
		i.	Are you a co-maker or endorser on a note?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
m.	Loan amount (exclude PMI, MIP, Funding Fee financed)	-----					
		j.	Are you a U.S. citizen?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
n.	PMI, MIP, Funding Fee financed	k.	Are you a permanent resident alien?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
o.	Loan amount (add m & n)	l.	Do you intend to occupy the property as your primary residence?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
		If Yes, complete question m below.					
p.	Cash from/to Borrower (subtract j, k, l & o from i)	m.	Have you had an ownership interest in a property in the last three years?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
		(1) What type of property did you own—principal residence (PR), second home (SH), or investment property (IP)?		_____	_____	_____	_____
		(2) How did you hold title to the home—by yourself (S), jointly with your spouse (SP), or jointly with another person (O)?		_____	_____	_____	_____

IX. ACKNOWLEDGEMENT AND AGREEMENT

Each of the undersigned specifically represents to Lender and to Lender's actual or potential agents, brokers, processors, attorneys, insurers, servicers, successors and assigns and agrees and acknowledges that: (1) the information provided in this application is true and correct as of the date set forth opposite my signature and that any intentional or negligent misrepresentation of this information contained in this application may result in civil liability, including monetary damages, to any person who may suffer any loss due to reliance upon any misrepresentation that I have made on this application, and/or in criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Sec. 1001, et seq.; (2) the loan requested pursuant to this application (the "Loan") will be secured by a mortgage or deed of trust on the property described in this application; (3) the property will not be used for any illegal or prohibited purpose or use; (4) all statements made in this application are made for the purpose of obtaining a residential mortgage loan; (5) the property will be occupied as indicated in this application; (6) the Lender, its servicers, successors or assigns may retain the original and/or an electronic record of this application, whether or not the Loan is approved; (7) the Lender and its agents, brokers, insurers, servicers, successors, and assigns may continuously rely on the information contained in the application, and I am obligated to amend and/or supplement the information provided in this application if any of the material facts that I have represented herein should change prior to closing of the Loan; (8) in the event that my payments on the Loan become delinquent, the Lender, its servicers, successors or assigns may, in addition to any other rights and remedies that it may have relating to such delinquency, report my name and account information to one or more consumer reporting agencies; (9) ownership of the Loan and/or administration of the Loan account may be transferred with such notice as may be required by law; (10) neither Lender nor its agents, brokers, insurers, servicers, successors or assigns has made any representation or warranty, express or implied, to me regarding the property or the condition or value of the property; and (11) my transmission of this application as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or my facsimile transmission of this application containing a facsimile of my signature, shall be as effective, enforceable and valid as if a paper version of this application were delivered containing my original written signature.

Acknowledgement. Each of the undersigned hereby acknowledges that any owner of the Loan, its servicers, successors and assigns, may verify or reverify any information contained in this application or obtain any information or data relating to the Loan, for any legitimate business purpose through any source, including a source named in this application or a consumer reporting agency.

Borrower's Signature X	Date	Co-Borrower's Signature X	Date
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X. INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the Federal Government for certain types of loans related to a dwelling in order to monitor the lender's compliance with equal credit opportunity, fair housing and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a lender may not discriminate either on the basis of this information, or on whether you choose to furnish it. If you furnish the information, please provide both ethnicity and race. For race, you may check more than one designation. If you do not furnish ethnicity, race, or sex, under Federal regulations, this lender is required to note the information on the basis of visual observation and surname if you have made this application in person. If you do not wish to furnish the information, please check the box below. (Lender must review the above material to assure that the disclosures satisfy all requirements to which the lender is subject under applicable state law for the particular type of loan applied for.)

BORROWER <input type="checkbox"/> I do not wish to furnish this information	CO-BORROWER <input type="checkbox"/> I do not wish to furnish this information
Ethnicity: <input type="checkbox"/> Hispanic or Latino <input type="checkbox"/> Not Hispanic or Latino	Ethnicity: <input type="checkbox"/> Hispanic or Latino <input type="checkbox"/> Not Hispanic or Latino
Race: <input type="checkbox"/> American Indian or Alaska Native <input type="checkbox"/> Asian <input type="checkbox"/> Black or African American <input type="checkbox"/> Native Hawaiian or Other Pacific Islander <input type="checkbox"/> White	Race: <input type="checkbox"/> American Indian or Alaska Native <input type="checkbox"/> Asian <input type="checkbox"/> Black or African American <input type="checkbox"/> Native Hawaiian or Other Pacific Islander <input type="checkbox"/> White
Sex: <input type="checkbox"/> Female <input type="checkbox"/> Male	Sex: <input type="checkbox"/> Female <input type="checkbox"/> Male

To be Completed by Loan Originator:
This information was provided:
 In a face-to-face interview
 In a telephone interview
 By the applicant and submitted by fax or mail
 By the applicant and submitted via e-mail or the Internet

Loan Originator's Signature X	Date	
Loan Originator's Name (print or type)	Loan Originator Identifier	Loan Originator's Phone Number (including area code)
Loan Origination Company's Name	Loan Origination Company Identifier	Loan Origination Company's Address

CONTINUATION SHEET/RESIDENTIAL LOAN APPLICATION		
Use this continuation sheet if you need more space to complete the Residential Loan Application. Mark B for Borrower or C for Co-Borrower.	Borrower:	Agency Case Number:
	Co-Borrower:	Lender Case Number:

I/We fully understand that it is a Federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

Borrower's Signature X	Date	Co-Borrower's Signature X	Date
----------------------------------	------	-------------------------------------	------

Appendix H: Request for Verification of Deposit



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.	

Appendix I: 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)
------------------------	----------	---------	-------------------------------

I have applied for a mortgage loan and stated that I am now or was formerly employed by you. My signature below authorizes verification of this information.

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				15. If paid hourly -- average hours per week	
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	\$ _____

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 _____	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.	

Appendix J: Sample Credit Report

Sample Credit Report

Page 1 of 4



Online Personal Credit Report from Experian for

Experian credit report prepared for
JOHN Q CONSUMER
 Your report number is
1562064065
 Report date:
04/24/2007

- Index:**
- Potentially negative items
 - Accounts in good standing
 - Requests for your credit history
 - Personal information
 - Important message from Experian
 - Contact us

Report number:

You will need your report number to contact Experian online, by phone or by mail.

Index:

Navigate through the sections of your credit report using these links.

Experian collects and organizes information about you and your credit history from public records, your creditors and other reliable sources. Experian makes your credit history available to your current and prospective creditors, employers and others as allowed by law, which can expedite your ability to obtain credit and can make offers of credit available to you. We do not grant or deny credit; each credit grantor makes that decision based on its own guidelines.

To return to your report in the near future, log on to www.experian.com/consumer and select "View your report again" or "Dispute" and then enter your report number.

If you disagree with information in this report, return to the Report Summary page and follow the instructions for disputing.

Potentially negative items:

Items that creditors may view less favorably. It includes the creditor's name and address, your account number (shortened for security), account status, type and terms of the account and any other information reported to Experian by the creditor. Also includes any bankruptcy, lien and judgment information obtained directly from the courts.

Potentially Negative Items

[back to top](#)

Public Records

Credit grantors may carefully review the items listed below when they check your credit history. Please note that the account information connected with some public records, such as bankruptcy, also may appear with your credit items listed later in this report.

MAIN COUNTY CLERK

Address: 123 MAINTOWN S BUFFALO , NY 10000	Identification Number: 1	Plaintiff: ANY COMMISSIONER O.
Status: Civil claim paid.	Status Details: This item was verified and updated in Apr 2007.	
Date Filed: 10/15/2006	Claim Amount: \$200	
Date Resolved: 03/04/2007	Liability: Amount: NA	
Responsibility: INDIVIDUAL		

Status:

Indicates the current status of the account.

Credit Items

For your protection, the last few digits of your account numbers do not display.

ABCD BANKS

Address: 100 CENTER RD BUFFALO, NY 10000 (555) 555-5555	Account Number: 1000000....	
Status: Paid/Past due 60 days.		
Date Opened: 10/2005	Type: Installment	Credit Limit/Original Amount: \$523
Reported Since: 11/2005	Terms: 12 Months	High Balance: NA
Date of Status: 04/2007	Monthly Payment: \$0	Recent Balance: \$0 as of 04/2007
Last Reported: 04/2007	Responsibility: Individual	Recent Payment: \$0
Account History: 60 days as of 12-2006 30 days as of 11-2006		



If you believe information in your report is inaccurate, you can dispute that item quickly, effectively and cost free by using Experian's online dispute service located at:

www.experian.com/disputes

Disputing online is the fastest way to address any concern you may have about the information in your credit report.

MAIN COLL AGENCIES

Address:	Account Number:	Original Creditor:
PO BOX 123 ANYTOWN, PA 10000 (555) 555-5555	0123456789	TELEWISE CABLE COMM.
Status: Collection account. \$95 past due as of 4-2000.		

Date Opened:	Type:	Credit Limit/Original Amount:
01/2005	Installment	\$95
Reported Since:	Terms:	High Balance:
04/2005	NA	NA
Date of Status:	Monthly	Recent Balance:
04/2005	Payment:	\$95 as of 04/2005
	\$0	Recent Payment:
		\$0
Last Reported:	Responsibility:	
04/2005	Individual	

Your statement: ITEM DISPUTED BY CONSUMER

Account History:
Collection as of 4-2005

Accounts in Good Standing

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AUTOMOBILE AUTO FINANCE

Address:	Account Number:
100 MAIN ST E SMALLTOWN, MD 90001 (555) 555-5555	12345678998....
Status: Open/Never late.	

Date Opened:	Type:	Credit Limit/Original Amount:
01/2006	Installment	\$10,355
Reported Since:	Terms:	High Balance:
01/2006	65 Months	NA
Date of Status:	Monthly	Recent Balance:
04/2007	Payment:	\$7,984 as of 04/2007
	\$210	Recent Payment:
		\$0
Last Reported:	Responsibility:	
04/2007	Individual	

MAIN

Address:	Account Number:
PO BOX 1234 FORT LAUDERDALE, FL 10009	1234567899876
Status: Closed/Never late.	

Date Opened:	Type:	Credit Limit/Original Amount:
03/1997	Revolving	NA
Reported Since:	Terms:	High Balance:
03/1997	1 Months	\$3,228
Date of Status:	Monthly	Recent Balance:
08/2006	Payment:	\$0 /paid as of 08/2006
	\$0	Recent Payment:
		\$0
Last Reported:	Responsibility:	
08/2006	Individual	

Your statement:
Account closed at consumer's request

Accounts in good standing:

Lists accounts that have a positive status and may be viewed favorably by creditors. Some creditors do not report to us, so some of your accounts may not be listed.

Type:

Account type indicates whether your account is a revolving or an installment account.

Requests for Your Credit History

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Requests Viewed By Others

We make your credit history available to your current and prospective creditors and employers as allowed by law. Personal data about you may be made available to companies whose products and services may interest you.

The section below lists all who have requested in the recent past to review your credit history as a result of actions involving you, such as the completion of a credit application or the transfer of an account to a collection agency, application for insurance, mortgage or loan application, etc. Creditors may view these requests when evaluating your creditworthiness.

HOMESALE REALTY CO

Address: 2000 S MAINROAD BLVD STE ANYTOWN CA 11111 (555) 555-5555	Date of Request: 07/16/2006
---	---------------------------------------

Comments:
Real estate loan on behalf of 3903 MERCHANTS EXPRESS M. This inquiry is scheduled to continue on record until 8-2008.

M & T BANK

Address: PO BOX 100 BUFFALO NY 10000 (555) 555-5555	Date of Request: 02/23/2006
---	---------------------------------------

Comments:
Permissible purpose. This inquiry is scheduled to continue on record until 3-2008.

WESTERN FUNDING INC

Address: 191 W MAIN AVE STE 100 INTOWN CA 10000 (559) 555-5555	Date of Request: 01/25/2006
--	---------------------------------------

Comments:
Permissible purpose. This inquiry is scheduled to continue on record until 2-2008.

Requests Viewed Only By You

The section below lists all who have a permissible purpose by law and have requested in the recent past to review your information. You may not have initiated these requests, so you may not recognize each source. We offer information about you to those with a permissible purpose, for example, to:

- | other creditors who want to offer you preapproved credit;
- | an employer who wishes to extend an offer of employment;
- | a potential investor in assessing the risk of a current obligation;
- | Experian or other credit reporting agencies to process a report for you;
- | your existing creditors to monitor your credit activity (date listed may reflect only the most recent request).

We report these requests **only to you** as a record of activities. We **do not** provide this information to other creditors who evaluate your creditworthiness.

MAIN BANK USA

Address: 1 MAIN CTR AA 11 BUFFALO NY 14203	Date of Request: 08/10/2006
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MYTOWN BANK

Address: PO BOX 825 MYTOWN DE 10000 (555) 555-5555	Date of Request: 08/05/2006
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INTOWN DATA CORPS

Address: 2000 S MAINTOWN BLVD STE INTOWN CO 11111 (555) 555-5555	Date of Request: 07/16/2006
--	---------------------------------------

Requests for your credit history:

Also called "inquiries," requests for your credit history are logged on your report whenever anyone reviews your credit information. There are two types of inquiries.

i. Inquiries resulting from a transaction initiated by you. These include inquiries from your applications for credit, insurance, housing or other loans. They also include transfer of an account to a collection agency. Creditors may view these items when evaluating your creditworthiness.

ii. Inquiries resulting from transactions you may not have initiated but that are allowed under the FCRA. These include preapproved offers, as well as for employment, investment review, account monitoring by existing creditors, and requests by you for your own report. These items are shown only to you and have no impact on your creditworthiness or risk scores.

Personal Information

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The following information is reported to us by you, your creditors and other sources. Each source may report your personal information differently, which may result in variations of your name, address, Social Security number, etc. As part of our fraud prevention efforts, a notice with additional information may appear. As a security precaution, the Social Security number that you used to obtain this report is not displayed. The Name identification number and Address identification number are how our system identifies variations of your name and address that may appear on your report. The Geographical Code shown with each address identifies the state, county, census tract, block group and Metropolitan Statistical Area associated with each address.

Names:
 JOHN Q CONSUMER
 Name identification number: 15621
 JONATHON Q CONSUMER
 Name identification number: 15622
 J Q CONSUMER
 Name identification number: 15623

Social Security number variations:
 999999999

Year of birth:
 1959

Spouse or co-applicant:
 JANE

Employers:
 ABCDE ENGINEERING CORP

Telephone numbers:
 (555) 555 5555 Residential

Address: 123 MAIN STREET
 ANYTOWN, MD 90001-9999
Address identification number:
 0277741504
Type of Residence: Multifamily
Geographical Code: 0-156510-31-8840

Address: 555 SIMPLE PLACE
 ANYTOWN, MD 90002-7777
Address identification number:
 0170086050
Type of Residence: Single family
Geographical Code: 0-176510-33-8840

Address: 999 HIGH DRIVE APT 15B
 ANYTOWN, MD 90003-5555
Address identification number:
 0170129301
Type of Residence: Apartment complex
Geographical Code: 0-156510-31-8840

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Personal information:

Personal information associated with your history that has been reported to Experian by you, your creditors and other sources.

May include name and Social Security number variations, employers, telephone numbers, etc. Experian lists all variations so you know what is being reported to us as belonging to you.

Address information:

Your current address and previous address(es)

Personal statement:

Any personal statement that you added to your report appears here.

Note - statements remain as part of the report for two years and display to anyone who has permission to review your report.

Your Personal Statement

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No general personal statements appear on your report.

Important Message From Experian

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By law, we cannot disclose certain medical information (relating to physical, mental, or behavioral health or condition). Although we do not generally collect such information, it could appear in the name of a data furnisher (i.e., "Cancer Center") that reports your payment history to us. If so, those names display in your report, but in reports to others they display only as MEDICAL PAYMENT DATA. Consumer statements included on your report at your request that contain medical information are disclosed to others.

Contacting Us

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Contact address and phone number for your area will display here.

Appendix K: Uniform Residential Appraisal Report

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

SUBJECT
 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)

CLIENT
 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).

CONTRACT
 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.

NEIGHBORHOOD
 Note: Race and the racial composition of the neighborhood are not appraisal factors.

Neighborhood Characteristics	One-Unit Housing Trends	One-Unit Housing	Present Land Use %
Location <input type="checkbox"/> Urban <input type="checkbox"/> Suburban <input type="checkbox"/> Rural	Property Values <input type="checkbox"/> Increasing <input type="checkbox"/> Stable <input type="checkbox"/> Declining	PRICE AGE One-Unit %	
Built-Up <input type="checkbox"/> Over 75% <input type="checkbox"/> 25-75% <input type="checkbox"/> Under 25%	Demand/Supply <input type="checkbox"/> Shortage <input type="checkbox"/> In Balance <input type="checkbox"/> Over Supply	\$ (000) (yrs) 2-4 Unit %	
Growth <input type="checkbox"/> Rapid <input type="checkbox"/> Stable <input type="checkbox"/> Slow	Marketing Time <input type="checkbox"/> Under 3 mths <input type="checkbox"/> 3-6 mths <input type="checkbox"/> Over 6 mths	Low Multi-Family %	
Neighborhood Boundaries		High Commercial %	
		Pred. Other %	

Neighborhood Description
 Market Conditions (including support for the above conclusions)

SITE
 Dimensions Area Shape View
 Specific Zoning Classification Zoning Description
 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)	Public	Other (describe)	Off-site Improvements—Type	Public	Private
Electricity	<input type="checkbox"/>	<input type="checkbox"/>	Water	<input type="checkbox"/>	Street	<input type="checkbox"/>	<input type="checkbox"/>
Gas	<input type="checkbox"/>	<input type="checkbox"/>	Sanitary Sewer	<input type="checkbox"/>	Alley	<input type="checkbox"/>	<input type="checkbox"/>

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

General Description	Foundation	Exterior Description	materials/condition	Interior	materials/condition
Units <input type="checkbox"/> One <input type="checkbox"/> One with Accessory Unit	<input type="checkbox"/> Concrete Slab <input type="checkbox"/> Crawl Space	Foundation Walls		Floors	
# of Stories	<input type="checkbox"/> Full Basement <input type="checkbox"/> Partial Basement	Exterior Walls		Walls	
Type <input type="checkbox"/> Det. <input type="checkbox"/> Att. <input type="checkbox"/> S-Det./End Unit	Basement Area sq. ft.	Roof Surface		Trim/Finish	
<input type="checkbox"/> Existing <input type="checkbox"/> Proposed <input type="checkbox"/> Under Const.	Basement Finish %	Gutters & Downspouts		Bath Floor	
Design (Style)	<input type="checkbox"/> Outside Entry/Exit <input type="checkbox"/> Sump Pump	Window Type		Bath Wainscot	
Year Built	Evidence of <input type="checkbox"/> Infestation	Storm Sash/Insulated		Car Storage <input type="checkbox"/> None	
Effective Age (Yrs)	<input type="checkbox"/> Dampness <input type="checkbox"/> Settlement	Screens		<input type="checkbox"/> Driveway # of Cars	
Attic <input type="checkbox"/> None	Heating <input type="checkbox"/> FWA <input type="checkbox"/> HWBB <input type="checkbox"/> Radiant	Amenities <input type="checkbox"/> Woodstove(s) #		Driveway Surface	
<input type="checkbox"/> Drop Stair <input type="checkbox"/> Stairs	<input type="checkbox"/> Other Fuel	<input type="checkbox"/> Fireplace(s) # <input type="checkbox"/> Fence		<input type="checkbox"/> Garage # of Cars	
<input type="checkbox"/> Floor <input type="checkbox"/> Scuttle	Cooling <input type="checkbox"/> Central Air Conditioning	<input type="checkbox"/> Patio/Deck <input type="checkbox"/> Porch		<input type="checkbox"/> Carport # of Cars	
<input type="checkbox"/> Finished <input type="checkbox"/> Heated	<input type="checkbox"/> Individual <input type="checkbox"/> Other	<input type="checkbox"/> Pool <input type="checkbox"/> Other		<input type="checkbox"/> Att. <input type="checkbox"/> Det. <input type="checkbox"/> Built-in	

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

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	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	Bdms.	Baths	Total	Bdms.	Baths	Total	Bdms.	Baths	
Room Count										
Gross Living Area	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) <input type="checkbox"/> + <input type="checkbox"/> - \$ _____ <input type="checkbox"/> + <input type="checkbox"/> - \$ _____ <input type="checkbox"/> + <input type="checkbox"/> - \$ _____										
Adjusted Sale Price of Comparables										
		Net Adj.	%	Net Adj.	%	Net Adj.	%	Net Adj.	%	
		Gross Adj.	%	Gross Adj.	%	Gross Adj.	%	Gross Adj.	%	
<input type="checkbox"/> did <input type="checkbox"/> did not research the sale or transfer history of the subject property and comparable sales. If not, explain _____										
My research <input type="checkbox"/> did <input type="checkbox"/> 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 <input type="checkbox"/> did <input type="checkbox"/> 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	COMPARABLE SALE # 1	COMPARABLE SALE # 2	COMPARABLE SALE # 3	COMPARABLE SALE # 1	COMPARABLE SALE # 2	
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 <input type="checkbox"/> "as is", <input type="checkbox"/> subject to completion per plans and specifications on the basis of a hypothetical condition that the improvements have been completed, <input type="checkbox"/> subject to the following repairs or alterations on the basis of a hypothetical condition that the repairs or alterations have been completed, or <input type="checkbox"/> 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.										

Uniform Residential Appraisal Report File #

A D D I T I O N A L C O M M E N T S				
	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)			
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)? <input type="checkbox"/> Yes <input type="checkbox"/> No Unit type(s) <input type="checkbox"/> Detached <input type="checkbox"/> 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)	
Was the project created by the conversion of an existing building(s) into a PUD? <input type="checkbox"/> Yes <input type="checkbox"/> No If Yes, date of conversion				
Does the project contain any multi-dwelling units? <input type="checkbox"/> Yes <input type="checkbox"/> No Data source(s)				
Are the units, common elements, and recreation facilities complete? <input type="checkbox"/> Yes <input type="checkbox"/> No If No, describe the status of completion.				
Are the common elements leased to or by the Homeowners' Association? <input type="checkbox"/> Yes <input type="checkbox"/> 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.

Uniform Residential Appraisal Report File # _____

21. The lender/client may disclose or distribute this appraisal report to: the borrower; another lender at the request of the borrower; the mortgagee or its successors and assigns; mortgage insurers; government sponsored enterprises; other secondary market participants; data collection or reporting services; professional appraisal organizations; any department, agency, or instrumentality of the United States; and any state, the District of Columbia, or other jurisdictions; without having to obtain the appraiser's or supervisory appraiser's (if applicable) consent. Such consent must be obtained before this appraisal report may be disclosed or distributed to any other party (including, but not limited to, the public through advertising, public relations, news, sales, or other media).
22. I am aware that any disclosure or distribution of this appraisal report by me or the lender/client may be subject to certain laws and regulations. Further, I am also subject to the provisions of the Uniform Standards of Professional Appraisal Practice that pertain to disclosure or distribution by me.
23. The borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, and other secondary market participants may rely on this appraisal report as part of any mortgage finance transaction that involves any one or more of these parties.
24. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.
25. Any intentional or negligent misrepresentation(s) contained in this appraisal report may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq., or similar state laws.

SUPERVISORY APPRAISER'S CERTIFICATION: The Supervisory Appraiser certifies and agrees that:

1. I directly supervised the appraiser for this appraisal assignment, have read the appraisal report, and agree with the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.
2. I accept full responsibility for the contents of this appraisal report including, but not limited to, the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.
3. The appraiser identified in this appraisal report is either a sub-contractor or an employee of the supervisory appraiser (or the appraisal firm), is qualified to perform this appraisal, and is acceptable to perform this appraisal under the applicable state law.
4. This appraisal report complies with 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.
5. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

APPRAISER

Signature _____
 Name _____
 Company Name _____
 Company Address _____

 Telephone Number _____
 Email Address _____
 Date of Signature and Report _____
 Effective Date of Appraisal _____
 State Certification # _____
 or State License # _____
 or Other (describe) _____ State # _____
 State _____
 Expiration Date of Certification or License _____

ADDRESS OF PROPERTY APPRAISED

APPRAISED VALUE OF SUBJECT PROPERTY \$ _____

LENDER/CLIENT
 Name _____
 Company Name _____
 Company Address _____

 Email Address _____

SUPERVISORY APPRAISER (ONLY IF REQUIRED)

Signature _____
 Name _____
 Company Name _____
 Company Address _____

 Telephone Number _____
 Email Address _____
 Date of Signature _____
 State Certification # _____
 or State License # _____
 State _____
 Expiration Date of Certification or License _____

SUBJECT PROPERTY

- Did not inspect subject property
 Did inspect exterior of subject property from street
 Date of Inspection _____
 Did inspect interior and exterior of subject property
 Date of Inspection _____

COMPARABLE SALES

- Did not inspect exterior of comparable sales from street
 Did inspect exterior of comparable sales from street
 Date of Inspection _____

Appendix L: Loan Estimate

FICUS BANK

4321 Random Boulevard • Somecity, ST 12340

Save this Loan Estimate to compare with your Closing Disclosure.

Loan Estimate

DATE ISSUED 2/15/2013
APPLICANTS Michael Jones and Mary Stone
 123 Anywhere Street
 Anytown, ST 12345
PROPERTY 456 Somewhere Avenue
 Anytown, ST 12345
SALE PRICE \$180,000

LOAN TERM 30 years
PURPOSE Purchase
PRODUCT Fixed Rate
LOAN TYPE Conventional FHA VA _____
LOAN ID # 123456789
RATE LOCK NO YES, until 4/16/2013 at 5:00 p.m. EDT

Before closing, your interest rate, points, and lender credits can change unless you lock the interest rate. All other estimated closing costs expire on 3/4/2013 at 5:00 p.m. EDT

Loan Terms		Can this amount increase after closing?
Loan Amount	\$162,000	NO
Interest Rate	3.875%	NO
Monthly Principal & Interest <i>See Projected Payments below for your Estimated Total Monthly Payment</i>	\$761.78	NO
Does the loan have these features?		
Prepayment Penalty	YES • As high as \$3,240 if you pay off the loan during the first 2 years	
Balloon Payment	NO	

Projected Payments		
Payment Calculation	Years 1-7	Years 8-30
Principal & Interest	\$761.78	\$761.78
Mortgage Insurance	+ 82	+ —
Estimated Escrow <i>Amount can increase over time</i>	+ 206	+ 206
Estimated Total Monthly Payment	\$1,050	\$968

Estimated Taxes, Insurance & Assessments <i>Amount can increase over time</i>	\$206 a month	This estimate includes <input checked="" type="checkbox"/> Property Taxes <input checked="" type="checkbox"/> Homeowner's Insurance <input type="checkbox"/> Other: <i>See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.</i>	In escrow? YES YES
---	------------------	--	---

Costs at Closing	
Estimated Closing Costs	\$8,054 Includes \$5,672 in Loan Costs + \$2,382 in Other Costs – \$0 in Lender Credits. <i>See page 2 for details.</i>
Estimated Cash to Close	\$16,054 Includes Closing Costs. <i>See Calculating Cash to Close on page 2 for details.</i>

Visit www.consumerfinance.gov/mortgage-estimate for general information and tools.

Additional Information About This Loan

LENDER Ficus Bank
NMLS/_ LICENSE ID
LOAN OFFICER Joe Smith
NMLS/_ LICENSE ID 12345
EMAIL joesmith@ficusbank.com
PHONE 123-456-7890

MORTGAGE BROKER
NMLS/_ LICENSE ID
LOAN OFFICER
NMLS/_ LICENSE ID
EMAIL
PHONE

Comparisons	Use these measures to compare this loan with other loans.	
In 5 Years	\$56,582	Total you will have paid in principal, interest, mortgage insurance, and loan costs.
	\$15,773	Principal you will have paid off.
Annual Percentage Rate (APR)	4.274%	Your costs over the loan term expressed as a rate. This is not your interest rate.
Total Interest Percentage (TIP)	69.45%	The total amount of interest that you will pay over the loan term as a percentage of your loan amount.

Other Considerations	
Appraisal	We may order an appraisal to determine the property's value and charge you for this appraisal. We will promptly give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost.
Assumption	If you sell or transfer this property to another person, we <input type="checkbox"/> will allow, under certain conditions, this person to assume this loan on the original terms. <input checked="" type="checkbox"/> will not allow assumption of this loan on the original terms.
Homeowner's Insurance	This loan requires homeowner's insurance on the property, which you may obtain from a company of your choice that we find acceptable.
Late Payment	If your payment is more than 15 days late, we will charge a late fee of 5% of the monthly principal and interest payment.
Refinance	Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.
Servicing	We intend <input type="checkbox"/> to service your loan. If so, you will make your payments to us. <input checked="" type="checkbox"/> to transfer servicing of your loan.

Confirm Receipt
 By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature _____ Date _____ Co-Applicant Signature _____ Date _____

Appendix M: Closing Disclosure

Closing Disclosure

This form is a statement of final loan terms and closing costs. Compare this document with your Loan Estimate.

Closing Information		Transaction Information		Loan Information	
Date Issued	4/15/2013	Borrower	Michael Jones and Mary Stone	Loan Term	30 years
Closing Date	4/15/2013		123 Anywhere Street	Purpose	Purchase
Disbursement Date	4/15/2013		Anytown, ST 12345	Product	Fixed Rate
Settlement Agent	Epsilon Title Co.	Seller	Steve Cole and Amy Doe	Loan Type	<input checked="" type="checkbox"/> Conventional <input type="checkbox"/> FHA
File #	12-3456		321 Somewhere Drive		<input type="checkbox"/> VA <input type="checkbox"/> _____
Property	456 Somewhere Ave	Lender	Anytown, ST 12345	Loan ID #	123456789
	Anytown, ST 12345		Ficus Bank	MIC #	000654321
Sale Price	\$180,000				

Loan Terms	Can this amount increase after closing?	
Loan Amount	\$162,000	NO
Interest Rate	3.875%	NO
Monthly Principal & Interest <i>See Projected Payments below for your Estimated Total Monthly Payment</i>	\$761.78	NO
	Does the loan have these features?	
Prepayment Penalty	YES • As high as \$3,240 if you pay off the loan during the first 2 years	
Balloon Payment	NO	

Projected Payments		
Payment Calculation	Years 1-7	Years 8-30
Principal & Interest	\$761.78	\$761.78
Mortgage Insurance	+ 82.35	+ —
Estimated Escrow <i>Amount can increase over time</i>	+ 206.13	+ 206.13
Estimated Total Monthly Payment	\$1,050.26	\$967.91
Estimated Taxes, Insurance & Assessments <i>Amount can increase over time See page 4 for details</i>	\$356.13 a month	This estimate includes <input checked="" type="checkbox"/> Property Taxes <input checked="" type="checkbox"/> Homeowner's Insurance <input checked="" type="checkbox"/> Other: Homeowner's Association Dues <i>See Escrow Account on page 4 for details. You must pay for other property costs separately.</i>
		In escrow? YES YES NO

Costs at Closing	
Closing Costs	\$9,712.10 Includes \$4,694.05 in Loan Costs + \$5,018.05 in Other Costs – \$0 in Lender Credits. See page 2 for details.
Cash to Close	\$14,147.26 Includes Closing Costs. See Calculating Cash to Close on page 3 for details.

Closing Cost Details

Loan Costs	Borrower-Paid		Seller-Paid		Paid by Others
	At Closing	Before Closing	At Closing	Before Closing	
A. Origination Charges	\$1,802.00				
01 0.25 % of Loan Amount (Points)	\$405.00				
02 Application Fee	\$300.00				
03 Underwriting Fee	\$1,097.00				
04					
05					
06					
07					
08					
B. Services Borrower Did Not Shop For	\$236.55				
01 Appraisal Fee to John Smith Appraisers Inc.					\$405.00
02 Credit Report Fee to Information Inc.		\$29.80			
03 Flood Determination Fee to Info Co.	\$20.00				
04 Flood Monitoring Fee to Info Co.	\$31.75				
05 Tax Monitoring Fee to Info Co.	\$75.00				
06 Tax Status Research Fee to Info Co.	\$80.00				
07					
08					
09					
10					
C. Services Borrower Did Shop For	\$2,655.50				
01 Pest Inspection Fee to Pests Co.	\$120.50				
02 Survey Fee to Surveys Co.	\$85.00				
03 Title – Insurance Binder to Epsilon Title Co.	\$650.00				
04 Title – Lender’s Title Insurance to Epsilon Title Co.	\$500.00				
05 Title – Settlement Agent Fee to Epsilon Title Co.	\$500.00				
06 Title – Title Search to Epsilon Title Co.	\$800.00				
07					
08					
D. TOTAL LOAN COSTS (Borrower-Paid)	\$4,694.05				
Loan Costs Subtotals (A + B + C)	\$4,664.25	\$29.80			
Other Costs					
E. Taxes and Other Government Fees	\$85.00				
01 Recording Fees Deed: \$40.00 Mortgage: \$45.00	\$85.00				
02 Transfer Tax to Any State			\$950.00		
F. Prepays	\$2,120.80				
01 Homeowner’s Insurance Premium (12 mo.) to Insurance Co.	\$1,209.96				
02 Mortgage Insurance Premium (mo.)					
03 Prepaid Interest (\$17.44 per day from 4/15/13 to 5/1/13)	\$279.04				
04 Property Taxes (6 mo.) to Any County USA	\$631.80				
05					
G. Initial Escrow Payment at Closing	\$412.25				
01 Homeowner’s Insurance \$100.83 per month for 2 mo.	\$201.66				
02 Mortgage Insurance per month for mo.					
03 Property Taxes \$105.30 per month for 2 mo.	\$210.60				
04					
05					
06					
07					
08 Aggregate Adjustment	-0.01				
H. Other	\$2,400.00				
01 HOA Capital Contribution to HOA Acre Inc.	\$500.00				
02 HOA Processing Fee to HOA Acre Inc.	\$150.00				
03 Home Inspection Fee to Engineers Inc.	\$750.00			\$750.00	
04 Home Warranty Fee to XYZ Warranty Inc.			\$450.00		
05 Real Estate Commission to Alpha Real Estate Broker			\$5,700.00		
06 Real Estate Commission to Omega Real Estate Broker			\$5,700.00		
07 Title – Owner’s Title Insurance (optional) to Epsilon Title Co.	\$1,000.00				
08					
I. TOTAL OTHER COSTS (Borrower-Paid)	\$5,018.05				
Other Costs Subtotals (E + F + G + H)	\$5,018.05				
J. TOTAL CLOSING COSTS (Borrower-Paid)	\$9,712.10				
Closing Costs Subtotals (D + I)	\$9,682.30	\$29.80	\$12,800.00	\$750.00	\$405.00
Lender Credits					

Calculating Cash to Close

Use this table to see what has changed from your Loan Estimate.

	Loan Estimate	Final	Did this change?
Total Closing Costs (J)	\$8,054.00	\$9,712.10	YES • See Total Loan Costs (D) and Total Other Costs (I)
Closing Costs Paid Before Closing	\$0	– \$29.80	YES • You paid these Closing Costs before closing
Closing Costs Financed (Paid from your Loan Amount)	\$0	\$0	NO
Down Payment/Funds from Borrower	\$18,000.00	\$18,000.00	NO
Deposit	– \$10,000.00	– \$10,000.00	NO
Funds for Borrower	\$0	\$0	NO
Seller Credits	\$0	– \$2,500.00	YES • See Seller Credits in Section L
Adjustments and Other Credits	\$0	– \$1,035.04	YES • See details in Sections K and L
Cash to Close	\$16,054.00	\$14,147.26	

Summaries of Transactions

Use this table to see a summary of your transaction.

BORROWER'S TRANSACTION

K. Due from Borrower at Closing		\$189,762.30
01	Sale Price of Property	\$180,000.00
02	Sale Price of Any Personal Property Included in Sale	
03	Closing Costs Paid at Closing (J)	\$9,682.30
04		
Adjustments		
05		
06		
07		
Adjustments for Items Paid by Seller in Advance		
08	City/Town Taxes to	
09	County Taxes to	
10	Assessments to	
11	HOA Dues 4/15/13 to 4/30/13	\$80.00
12		
13		
14		
15		
L. Paid Already by or on Behalf of Borrower at Closing		\$175,615.04
01	Deposit	\$10,000.00
02	Loan Amount	\$162,000.00
03	Existing Loan(s) Assumed or Taken Subject to	
04		
05	Seller Credit	\$2,500.00
Other Credits		
06	Rebate from Epsilon Title Co.	\$750.00
07		
Adjustments		
08		
09		
10		
11		
Adjustments for Items Unpaid by Seller		
12	City/Town Taxes 1/1/13 to 4/14/13	\$365.04
13	County Taxes to	
14	Assessments to	
15		
16		
17		
CALCULATION		
Total Due from Borrower at Closing (K)		\$189,762.30
Total Paid Already by or on Behalf of Borrower at Closing (L)		– \$175,615.04
Cash to Close <input checked="" type="checkbox"/> From <input type="checkbox"/> To Borrower		\$14,147.26

SELLER'S TRANSACTION

M. Due to Seller at Closing		\$180,080.00
01	Sale Price of Property	\$180,000.00
02	Sale Price of Any Personal Property Included in Sale	
03		
04		
05		
06		
07		
08		
Adjustments for Items Paid by Seller in Advance		
09	City/Town Taxes to	
10	County Taxes to	
11	Assessments to	
12	HOA Dues 4/15/13 to 4/30/13	\$80.00
13		
14		
15		
16		
N. Due from Seller at Closing		\$115,665.04
01	Excess Deposit	
02	Closing Costs Paid at Closing (J)	\$12,800.00
03	Existing Loan(s) Assumed or Taken Subject to	
04	Payoff of First Mortgage Loan	\$100,000.00
05	Payoff of Second Mortgage Loan	
06		
07		
08	Seller Credit	\$2,500.00
09		
10		
11		
12		
13		
Adjustments for Items Unpaid by Seller		
14	City/Town Taxes 1/1/13 to 4/14/13	\$365.04
15	County Taxes to	
16	Assessments to	
17		
18		
19		
CALCULATION		
Total Due to Seller at Closing (M)		\$180,080.00
Total Due from Seller at Closing (N)		– \$115,665.04
Cash <input type="checkbox"/> From <input checked="" type="checkbox"/> To Seller		\$64,414.96

Additional Information About This Loan

Loan Disclosures

Assumption

If you sell or transfer this property to another person, your lender

- will allow, under certain conditions, this person to assume this loan on the original terms.
- will not allow assumption of this loan on the original terms.

Demand Feature

Your loan

- has a demand feature, which permits your lender to require early repayment of the loan. You should review your note for details.
- does not have a demand feature.

Late Payment

If your payment is more than 15 days late, your lender will charge a late fee of 5% of the monthly principal and interest payment.

Negative Amortization (Increase in Loan Amount)

Under your loan terms, you

- are scheduled to make monthly payments that do not pay all of the interest due that month. As a result, your loan amount will increase (negatively amortize), and your loan amount will likely become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
- may have monthly payments that do not pay all of the interest due that month. If you do, your loan amount will increase (negatively amortize), and, as a result, your loan amount may become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
- do not have a negative amortization feature.

Partial Payments

Your lender

- may accept payments that are less than the full amount due (partial payments) and apply them to your loan.
- may hold them in a separate account until you pay the rest of the payment, and then apply the full payment to your loan.
- does not accept any partial payments.

If this loan is sold, your new lender may have a different policy.

Security Interest

You are granting a security interest in
456 Somewhere Ave., Anytown, ST 12345

You may lose this property if you do not make your payments or satisfy other obligations for this loan.

Escrow Account

For now, your loan

- will have an escrow account (also called an "impound" or "trust" account) to pay the property costs listed below. Without an escrow account, you would pay them directly, possibly in one or two large payments a year. Your lender may be liable for penalties and interest for failing to make a payment.

Escrow		
Escrowed Property Costs over Year 1	\$2,473.56	Estimated total amount over year 1 for your escrowed property costs: <i>Homeowner's Insurance</i> <i>Property Taxes</i>
Non-Escrowed Property Costs over Year 1	\$1,800.00	Estimated total amount over year 1 for your non-escrowed property costs: <i>Homeowner's Association Dues</i> You may have other property costs.
Initial Escrow Payment	\$412.25	A cushion for the escrow account you pay at closing. See Section G on page 2.
Monthly Escrow Payment	\$206.13	The amount included in your total monthly payment.

- will not have an escrow account because you declined it your lender does not offer one. You must directly pay your property costs, such as taxes and homeowner's insurance. Contact your lender to ask if your loan can have an escrow account.

No Escrow		
Estimated Property Costs over Year 1		Estimated total amount over year 1. You must pay these costs directly, possibly in one or two large payments a year.
Escrow Waiver Fee		

In the future,

Your property costs may change and, as a result, your escrow payment may change. You may be able to cancel your escrow account, but if you do, you must pay your property costs directly. If you fail to pay your property taxes, your state or local government may (1) impose fines and penalties or (2) place a tax lien on this property. If you fail to pay any of your property costs, your lender may (1) add the amounts to your loan balance, (2) add an escrow account to your loan, or (3) require you to pay for property insurance that the lender buys on your behalf, which likely would cost more and provide fewer benefits than what you could buy on your own.

Loan Calculations

Total of Payments. Total you will have paid after you make all payments of principal, interest, mortgage insurance, and loan costs, as scheduled.	\$285,803.36
Finance Charge. The dollar amount the loan will cost you.	\$118,830.27
Amount Financed. The loan amount available after paying your upfront finance charge.	\$162,000.00
Annual Percentage Rate (APR). Your costs over the loan term expressed as a rate. This is not your interest rate.	4.174%
Total Interest Percentage (TIP). The total amount of interest that you will pay over the loan term as a percentage of your loan amount.	69.46%

Questions? If you have questions about the loan terms or costs on this form, use the contact information below. To get more information or make a complaint, contact the Consumer Financial Protection Bureau at www.consumerfinance.gov/mortgage-closing

Other Disclosures

Appraisal

If the property was appraised for your loan, your lender is required to give you a copy at no additional cost at least 3 days before closing. If you have not yet received it, please contact your lender at the information listed below.

Contract Details

See your note and security instrument for information about

- what happens if you fail to make your payments,
- what is a default on the loan,
- situations in which your lender can require early repayment of the loan, and
- the rules for making payments before they are due.

Liability after Foreclosure

If your lender forecloses on this property and the foreclosure does not cover the amount of unpaid balance on this loan,

- state law may protect you from liability for the unpaid balance. If you refinance or take on any additional debt on this property, you may lose this protection and have to pay any debt remaining even after foreclosure. You may want to consult a lawyer for more information.
- state law does not protect you from liability for the unpaid balance.

Refinance

Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.

Tax Deductions

If you borrow more than this property is worth, the interest on the loan amount above this property's fair market value is not deductible from your federal income taxes. You should consult a tax advisor for more information.

Contact Information

	Lender	Mortgage Broker	Real Estate Broker (B)	Real Estate Broker (S)	Settlement Agent
Name	Ficus Bank		Omega Real Estate Broker Inc.	Alpha Real Estate Broker Co.	Epsilon Title Co.
Address	4321 Random Blvd. Somecity, ST 12340		789 Local Lane Sometown, ST 12345	987 Suburb Ct. Someplace, ST 12340	123 Commerce Pl. Somecity, ST 12344
NMLS ID					
ST License ID			Z765416	Z61456	Z61616
Contact	Joe Smith		Samuel Green	Joseph Cain	Sarah Arnold
Contact NMLS ID	12345				
Contact ST License ID			P16415	P51461	PT1234
Email	joesmith@ficusbank.com		sam@omegare.biz	joe@alphare.biz	sarah@epsilontitle.com
Phone	123-456-7890		123-555-1717	321-555-7171	987-555-4321

Confirm Receipt

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature _____ Date _____

Co-Applicant Signature _____ Date _____

Glossary

- abstract of title** A condensed history of the title to a property, consisting of a summary of the original grant and all subsequent conveyances and encumbrances relating to the particular parcel of real estate.
- acceleration clause** The clause in a mortgage or trust deed that stipulates that the entire debt is due immediately if the borrower defaults under the terms of the contract.
- actual notice** Express information or fact; that which is known; direct knowledge.
- ad valorem** Property taxed according to its value.
- adjustable-rate mortgage (ARM)** A mortgage loan that has an interest rate that is changed (adjusted) periodically based upon an index agreed to between a borrower and a lender.
- administered price system** System by which Fannie Mae adjusts required yields in accordance with market factors and its financial needs.
- allowable closing costs** Costs of closing that follow FHA guidelines as to what may be charged to the borrower; the seller may contribute up to 6% of the sales price to cover points and other allowable closing costs.
- American Recovery and Reinvestment Act of 2009 (ARRA)** The first of the government's programs dedicated to restoring the American economy; also called the *Stimulus Act*.
- American Taxpayer Relief Act of 2012** This act retained some aspects of Taxpayer Relief Act of 1997, while eliminating others.
- amortization** The systematic repayment of a loan by periodic installments of principal and interest over the entire term of the loan agreement.
- annual percentage rate (APR)** The effective or actual interest rate, which may be higher or lower than the nominal or contract interest rate because it includes loan closing costs.
- appraisal** An estimate of value. An appraisal of real property value is based on a comparison of real estate prices as well as the current market for real estate.
- assets** All things of value owned by a person or corporation, whether encumbered or not.
- assumed** A loan that may be taken over (assumed) by a buyer when purchasing a parcel of real estate. Often requires the lender to approve the new buyer.
- baby boomers** Persons born between 1946 and 1964.
- balloon payment** A final payment of a mortgage loan that is considerably larger than the required periodic payments because the loan amount was not fully amortized.
- bearer bonds** Interest is paid to any person having the bonds in the person's possession.
- beneficiary** In a trust agreement, the entity in whom the property will vest at the completion of the trust term.
- blanket mortgage** A mortgage secured by pledging more than one property as collateral.
- boot** Money or property given to make up any difference in value or equity between two properties in a 1031 exchange.

broker price opinion (BPO) An opinion of real estate value commissioned by a bank or attorney and provided by a broker.

buydown A financing technique used to reduce the monthly payments for the first few years of a loan. Funds in the form of discount points are given to the lender by the builder or seller to buy down or lower the effective interest rate paid by the buyer, thus reducing the monthly payments for a set time.

capitalization rate The rate of return, based on purchase price, that would attract capital.

carryback loan The seller holds a portion of the sales price as a junior encumbrance.

certificate of eligibility A form issued by the VA that states the amount of loan guarantee entitlement for which the veteran is eligible.

certificate of reasonable value (CRV) A form indicating the appraised value of a property being financed with a VA loan.

Closing Disclosure A final account of all costs of a mortgage loan; it replaces the HUD-1 Settlement Statement.

cloud on the title Any document, claim, unreleased lien, or encumbrance that may impair the title to real property or make the title doubtful; usually revealed by a title search and removed by either a quitclaim deed or suit to quiet title.

collateral Property, real or personal, pledged as security to back up a promise to repay a debt.

collateralized mortgage obligation (CMO) A type of mortgage-backed security that creates separate pools of pass-through rates for different classes of bondholders with varying maturities, called tranches. The repayments from the pool of pass-through securities are used to retire the bonds in the order specified by the bonds' prospectus.

commercial paper Mortgage loans establishing commercial property as collateral.

Community Development Block Grant Program (CDBG) FHA program issuing grants to communities for economic development, job opportunities, and housing rehabilitation.

Community Reinvestment Act (CRA) Under the act, financial institutions are expected to meet the deposit and credit needs of their communities; became a significant factor in the growth of bank mergers starting in the 1990s.

completion bond A surety bond posted by a landowner or developer to guarantee that a proposed development will be completed according to specifications, free and clear of all mechanics' liens.

conforming loan Any mortgage loan that meets the qualifying standards set by Fannie Mae and Freddie Mac. The maximum loan limit is set each year by the Federal Housing Finance Agency.

constructive notice Notice given to the world by recorded documents.

Consumer Financial Protection Bureau (CFPB) Established in 2010 under the Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) as an independent agency setting rules and regulations for any business providing financial services to consumers.

contract for deed A contract under which the purchase price is paid in installments over a period of time during which the purchaser has possession of the property but the seller retains title until the contract terms are completed; usually drawn between individuals. Also called a *land contract*, *installment contract*, or *agreement of sale*.

correspondents Another name for mortgage bankers who both originate and service mortgage loans on behalf of investors.

cost approach The process of appraising the value of a property by adding to the estimated value of the land the appraiser's calculations of the replacement cost of the building, less depreciation.

coupon bonds A type of corporate bond with interest coupons attached that may be cashed by the bearer of the bond.

credit report An itemization of the status of an individual's credit history.

credit score An objective method of assessing credit risk based on the statistical probability of debt repayment.

- cross-defaulting clause** A provision in a mortgage that triggers a default on a second mortgage if there is a default on the first mortgage.
- debentures** Unsecured bonds that are a claim against the general assets of a corporation.
- deed in lieu of foreclosure** To avoid a foreclosure action, a defaulting borrower may voluntarily convey the collateral to the lender.
- deed of trust** *See* trust deed.
- default** Nonperformance of a duty; failure to meet an obligation when due.
- defeasance clause** A clause used in leases and mortgages that cancels a specified right upon the occurrence of a certain condition, such as cancellation of a mortgage upon repayment of the mortgage loan.
- deficiency judgment** The difference in the amount received at an auction of defaulted property between the amount owed and the amount received as an award to the lender.
- demand deposits** Bank deposits that must be available on demand (e.g., checking accounts).
- depreciation** In appraisal, the loss of value due to physical deterioration, functional obsolescence, or economic obsolescence. In accounting, the allowable deduction for the recapture of the investment.
- Desktop Originator® (DO)** Fannie Mae's automated underwriting system for independent mortgage broker/agents.
- Desktop Underwriter® (DU)** Fannie Mae's automated underwriting system for lender services.
- direct endorsement program** Allows approved lenders to underwrite FHA loans; leaves the FHA with risk of default, but the FHA can remove the lender from the program.
- direct sales comparison approach** The process of estimating the value of a property by examining and comparing actual sales of comparable properties.
- discount rate** The rate of interest charged by the Federal Reserve to its member banks to borrow money.
- disintermediation** A situation when more funds are being withdrawn from financial institutions than are being deposited.
- draws** A system of payments made by a lender to a contractor as designated stages of a building's construction are completed.
- drive-by appraisal** Appraiser only observes exterior of the property, with no interior inspection.
- due-on-sale clause** A clause in a mortgage or trust deed that stipulates that a borrower cannot sell or transfer the property without prior written consent of the lender. Also called an *alienation clause*.
- echo boomers** Offspring of the baby boomer generation; suffering from current difficult economic times.
- encumbrance** Anything—such as a mortgage, tax, or judgment lien; an easement; a restriction on the use of the land; or an outstanding dower right—that may diminish the value or use and enjoyment of a property.
- Energy Efficient Mortgage (EEM)** Mortgage that includes funding for energy-efficient features to new or existing houses.
- entitlement** The amount of the sales price guaranteed by the VA for a VA mortgage loan.
- entitlement communities** Designated communities eligible for Community Development Block Grant (CDBG) funds.
- Equal Credit Opportunity Act (ECOA)** The federal law that prohibits discrimination in the extension of credit because of race, color, religion, national origin, sex, age, marital status, or source of income.
- equitable redemption period** Time granted before the sale of the property, allowing the borrower to make up late payments and charges; length varies by state.
- equitable right of redemption** The right of a defaulted property owner to recover the property prior to its sale by paying the appropriate fees and charges.
- equitable title** The interest held by a vendee under a contract for deed or an installment contract; the equitable right to obtain absolute ownership to property when legal title is held in another's name.
- equity loan** Money borrowed on accumulated equity.
- escrow funds** Funds collected by the lender to pay property taxes and homeowners insurance; also called *impound funds* in some states.
- eviction** The legal dispossession of an errant borrower or tenant.

exculpatory clause Stipulates that the borrower's liability is limited to the property designated in the legal description.

Fannie Mae A government-sponsored enterprise established to purchase any kind of mortgage loans in the secondary mortgage market from the primary lenders.

Federal Deposit Insurance Corporation (FDIC) A federal agency that provides insurance of \$250,000 per depositor account and supervises the operations of banks and thrifts.

federal funds rate The rate recommended by the Federal Reserve for the member banks to charge each other on short-term loans. These rates form the basis on which the banks determine the percentage rate of interest they will charge their loan customers.

Federal Home Loan Bank (FHLB) Organized in 1932 to provide central clearing facilities and regulations for savings associations; now under supervision of Federal Housing Finance Agency (FHFA). Serves as secondary market for its members.

Federal Housing Finance Agency (FHFA) Created in 2008 under the Housing and Economic Recovery Act to oversee Fannie Mae, Freddie Mac, and the Federal Home Loan Banks; currently acting as conservator for Fannie Mae and Freddie Mac.

FICO System for determining credit score developed by Fair, Isaac & Company.

fiduciary responsibility A relationship that implies a position of trust or confidence wherein one person is usually entrusted to hold or manage property or money for another.

financial intermediaries Financial fiduciary institution that acts as an intermediary between savers and borrowers.

financial statement A standardized form listing all of an applicant's assets and liabilities.

fixed-rate loan A loan where the interest rate stays constant for the life of the loan.

forbearance An agreement by the lender for a full or partial waiver of payment for a set period of time.

Freddie Mac A government-sponsored enterprise established to purchase primarily conventional mortgage loans in the secondary mortgage market.

funding fee An amount charged on a VA loan to protect the VA in case of default by the borrower; amount varies according to time in service.

general obligation bonds System of financing in which the community is held responsible for making payments for capital improvements, usually included in property taxes.

Generation X Generally considered to be those born between 1965 and 1976; tend to marry later and have a higher divorce rate and lower remarriage rate, resulting in a higher percentage of persons living alone.

Ginnie Mae A government agency that plays an important role in the secondary mortgage market. It guarantees mortgage-backed securities using FHA and VA loans as collateral.

Good Faith Estimate (GFE) An estimate of all closing fees that must be provided to a borrower within three days of the loan application as required by the Real Estate Settlement Procedures Act (RESPA).

government-sponsored enterprise (GSE) Term used for Fannie Mae, Freddie Mac, and Federal Home Loan Bank—all independent entities receiving favorable tax benefits and line of credit with Department of the Treasury; now under supervision of Federal Housing Finance Agency.

grace period Time allowed by a lender before enforcing a penalty for late payment.

granting clause Words in a deed of conveyance that state the grantor's intention to convey the property at the present time. This clause is generally worded as "convey and warrant"; "grant"; "grant, bargain, and sell"; or the like.

gross rent multiplier (GRM) The figure used as a multiplier of the gross monthly income of a property to produce an estimate of the property's value.

hazard insurance Insurance that only covers physical hazards to the property.

Home Affordable Modification Program (HAMP) A program for modifying a mortgage loan in order for the payment to become within the borrower's ability to pay.

Home Affordable Refinance Program (HARP) A program of refinancing specifically designed for homeowners not eligible for the HAMP.

- Home Equity Conversion Mortgage (HECM)** FHA's reverse mortgage program designed to provide extra income for those 62 years of age or older.
- Home Equity Line of Credit (HELOC)** A version of a home equity loan where the borrower can draw down from an established line-of-credit amount, only paying interest on the amount of funds withdrawn.
- Home Mortgage Disclosure Act (HMDA)** A federal law that requires lenders to annually disclose the number of loan applications and loans in certain areas, thus eliminating the practice of redlining.
- homeowners insurance** A standardized package insurance policy that covers a residential real estate owner against financial loss from fire, theft, public liability, and other common risks.
- HOPE NOW** A special hotline number that borrowers at risk of foreclosure can call for advice.
- Housing and Economic Recovery Act of 2008 (HERA)** Created the Federal Housing Finance Agency to regulate the GSEs; also created the Neighborhood Stabilization Program to assist communities suffering from large number of foreclosures.
- Housing Choice Voucher Program** Provides rental assistance to eligible consumers and allows funds to be used towards mortgage payment. Formerly called *Section 8*.
- housing ratio** A percentage of gross monthly income set aside for total housing expense, including principal, interest, taxes, homeowners insurance, mortgage insurance, and any condominium or homeowners association fees.
- HUD-1 Settlement Statement** A form that itemizes fees and services charged to a borrower and seller during a real estate transaction.
- hypothecation** The act of pledging real estate as security without surrendering possession of the property.
- impound funds** Funds collected by the lender along with mortgage payment to pay for property taxes and homeowners insurance. Also called *escrow funds*.
- income approach** A process of estimating the value of an income-producing property by capitalization of its net operating income.
- industrial development bonds** Securities issued to pay for the development of a new industry, usually in the form of general obligation bonds.
- industrial revenue bonds (IRBs)** Bonds backed by a state's bonding credit to raise funds for the purchase and improvement of land for industrial and office parks.
- interest rate factor** The number of dollars it takes to pay down \$1,000 of a loan based on the interest rate and term of the loan.
- interest-only loans** A loan that only requires the payment of interest for a stated period of time with the principal due at the end of the term.
- interim financing** An open-end mortgage loan, usually for a short term, obtained to finance the actual construction of buildings on a property.
- Internal Revenue Code Section 1031** Allows recognition of gain for tax purposes to be postponed by exchanging like kind income-producing properties.
- Interstate Land Sales Full Disclosure Act (ILSFDA)** A federal law that regulates interstate land sales by requiring registration of real property and disclosure of full and accurate information regarding the property to prospective buyers.
- involuntary lien** A lien placed on property without the consent of the property owner.
- judgment decree** Process by which a court orders the sale of property at public auction.
- judicial foreclosure** Foreclosure requiring court order and sale at public auction.
- jumbo loans** Any loan exceeding the current Fannie Mae/Freddie Mac conforming loan limit.
- junior financing** Any type of secondary (or tertiary) loan where there is a first mortgage in place.
- lease option** A lease under which the tenant has the right to purchase the property either during the lease term or at its end.
- lease purchase** The purchase of real property, the consummation of which is preceded by a lease, usually long-term, that is typically done for tax or financing purposes.
- leverage** Use of borrowed money to finance the purchase of an investment.
- liabilities** Debts incurred.
- lien theory** Some states interpret a mortgage as being purely a lien on real property. The mortgagee thus has no right of possession but must foreclose the lien and sell the property if the mortgagor defaults.

lifting clause A clause in a junior mortgage allowing a borrower to replace an existing first mortgage without disturbing the status of the junior mortgage.

Loan Estimate The required disclosure of all costs of obtaining a mortgage loan; it replaces the GFE and TILA disclosures.

Loan Prospector[®] Freddie Mac's automated underwriting system.

loan-to-value (LTV) ratio The relationship between the amount of the mortgage loan and the value of the real estate being pledged as collateral.

M1 Measure of the total money supply; money easily available, such as cash, checking accounts, and demand deposits.

M2 Measure of the total money supply; all of M1, plus money market funds, retirement accounts, and deposits under \$100,000.

M3 Measure of the total money supply; all of M2, plus deposits over \$100,000, money on deposit overseas, and institutional money market funds.

manufactured housing Prefabricated homes built in a factory and transported to a lot for installation.

market value The highest price for which a property would sell, assuming a reasonable time for the sale and a knowledgeable buyer and seller acting without duress.

moratorium A temporary suspension of payments due under a financing agreement to help a distressed borrower recover and avoid a default and foreclosure.

mortgage bankers A financial intermediary who originates new mortgage loans, collects payments, inspects the collateral, and forecloses, if necessary.

mortgage brokers One who acts as an intermediary between borrower and lender for a real estate loan, thereby earning a placement fee.

Mortgage Forgiveness Debt Relief Act of 2007 Relieves borrower from liability to pay taxes on any monies forgiven by a bank due to a short sale or foreclosure.

mortgage insurance premium (MIP) A fee paid to assure lenders that in the event a borrower does not make the required mortgage payments, the insurance company will.

mortgage revenue bonds Tax-exempt bonds used to make below-market interest rate loans to developers in redevelopment projects or for low-cost mortgages for first-time homebuyers.

mortgage-backed securities (MBSs) Packages of mortgage loans sold on the open market; some pools may be of the same type loans, while others may be multiple-issue pools.

mortgagee A lender in a mortgage loan transaction.

mortgagor A borrower in a mortgage loan transaction.

municipal bonds Bonds issued by a municipality, county, or state to finance community improvements.

negative amortization Less than interest-only loan payments, which cause the balance of a loan to increase by the amount of the deficient interest.

Neighborhood Stabilization Program (NSP) Part of the Housing and Economic Recovery Act of 2008 that provides grants to communities suffering from an excess number of foreclosures.

net worth Assets less liabilities.

nonconforming loan Any loan that does not conform to the Fannie Mae/Freddie Mac qualifying guidelines, including maximum loan amount.

nonrecourse clause Relieves the seller from liability if the borrower defaults.

note A signed instrument acknowledging a debt and promising repayment.

note and mortgage A note can stand alone, but a mortgage must be accompanied by a note in order to be legally enforceable.

novation Substituting a new obligation for an old one or substituting new parties to an existing obligation.

open-market operations The Fed's activities in buying and selling securities to control the money supply.

origination fee Fee charged by a lender to cover costs of originating the loan; frequently 1% of the loan amount.

package mortgage A real estate loan used to finance the purchase of both real property and personal property, such as in the purchase of a new home that includes carpeting, window coverings, and major appliances.

- par** With regard to mortgage loans, means bought at full-face value.
- partial entitlement** A veteran who has used the full entitlement in the past may be eligible for additional entitlement if the guarantee amount has increased; subtract the amount previously used from the current entitlement to obtain the partial entitlement. The bank will lend four times that amount with zero money down payment.
- participation certificates (PCs)** Another name for mortgage-backed securities sold by Freddie Mac.
- participation financing** When the lender requires an equity position in the property being financed.
- pass-through certificates** Mortgage-backed securities where the principal and interest payments are passed through to the investor in one of several different formats.
- piggy-back loan** When the borrower takes out a first and second mortgage simultaneously in order to avoid private mortgage insurance (there is no PMI as long as first mortgage is 80% or less).
- point** A percentage of the principal loan amount charged by the lender. Each point is equal to 1% of the loan amount.
- power of sale** In a deed of trust, authorizes the trustee to proceed with the sale of the property.
- power-of-sale method** A nonjudicial type of foreclosure usually performed by exercising the trustee rights under a deed of trust.
- predatory lending** The practice of charging excessive interest rates and fees to unsuspecting borrowers.
- premium** 1. In discounting, a payment of more than face value for a security. 2. In insurance, the fee paid for coverage.
- prepayment clause** A clause in a mortgage or trust deed that provides for a penalty to be levied against a borrower who repays a loan before the specified due date.
- primary lender** Institutions that make mortgage loans; primarily banks, savings associations, credit unions, mortgage brokers, and mortgage bankers.
- primary market** The mortgage market in which loans are originated and consisting of lenders such as commercial banks, savings associations, and mutual savings banks.
- prime rate** The interest rate a lender charges its most creditworthy customers.
- private mortgage insurance (PMI)** Mortgage insurance issued by companies not associated with the federal government.
- property report** The mandatory federal and state documents compiled by subdividers and developers to provide potential purchasers with facts about a property prior to their purchase.
- qualified residential mortgage (QRM)** A new standard of qualifying being considered by Fannie Mae and Freddie Mac where the lender must retain part of the risk for any mortgage loan with less than a 20% down payment.
- quantitative easing** A Fed program to purchase mortgage-backed securities and long-term Treasury notes.
- real estate cycle** Historically, real estate goes around in short-term (three to five years) and long-term (10 to 15 years) cycles. The ability to forecast future cycles is significant to investors.
- real estate investment trust (REIT)** An unincorporated trust set up to invest in real estate that must have at least 100 investors, with management, control, and title to the property in the hands of trustees.
- real estate mortgage investment conduits (REMICs)** A pool of mortgages in which investors may purchase proportionate interests.
- real estate mortgage trust (REMT)** A business trust, similar to a REIT, that invests in mortgage securities rather than in real estate.
- Real Estate Settlement Procedures Act (RESPA)** The federal law that requires certain disclosures to consumers about mortgage loan settlements. The law also prohibits the payment or receipt of kickbacks and certain kinds of referral fees.
- recast** A lender can reconfigure the remaining balance into a new loan over a new term, resulting in a reduction in the monthly payment.
- reconciliation** The final step in the appraisal process, in which the appraiser combines the estimates of value received from the sales comparison, cost, and income approaches to arrive at a final estimate of market value for the subject property.

registered bonds Bonds issued to a specific owner that cannot be transferred without the owner's endorsement; interest is paid to the last registered owner.

Regulation Z The truth-in-lending portion of the Consumer Credit Protection Act of 1968. It requires complete disclosure of the total costs involved in most credit activities.

rehabilitation loan FHA 203(k) A special type of FHA loan that provides funds to both purchase the property and make needed repairs and improvements.

release clause A clause included in a blanket mortgage that provides that on payment of a specific sum of money, the lien on a particular parcel or portion of the collateral will be released.

release of liability Releases the veteran seller from any remaining liability for a default on the loan.

reserve requirements The Fed requires its members to keep a certain percentage of the bank's total funds on deposit with its federal district bank. The Fed can change the amount of reserves required to help control the flow of money in the country.

residual income On a VA loan, the lender must also take into account how much money will be left over (residual) after making the mortgage payment plus other fixed expenses. If the residual income is not considered sufficient, the loan will not be approved.

revenue bonds Bonds to be repaid by the fees charged for the use of the funded project.

reverse annuity mortgage (RAM) A loan under which the homeowner receives payments based on the accumulated equity; payment may be monthly, a lump sum, or established as a line-of-credit. The loan must be repaid at a prearranged date, upon the death of the owner, or upon the sale of the property. The FHA reverse mortgage is called a *Home Equity Conversion Mortgage (HECM)*.

right of first refusal The right of a person to have the first opportunity to either purchase or lease a specific parcel of real property.

robo-signing When a bank official signs off on numerous foreclosure papers without adequate research; blamed for some of the current foreclosure problems.

second mortgage Junior financing; a second mortgage issued on top of an existing first mortgage. Also called a *second deed of trust*.

secondary market A marketplace in which mortgages and trust deeds are traded. *See also* Fannie Mae, Freddie Mac, and Ginnie Mae.

Secure and Fair Enforcement Mortgage Licensing Act (SAFE Act) Designed to provide more control over those dealing with financial issues for the consumer.

securities Something given, deposited, or pledged to make secure the fulfillment of an obligation, usually the repayment of a debt. Generically, mortgages, trust deeds, and other financing instruments backed by collateral pledges are termed securities for investment purposes.

shadow inventory Homes that are delinquent or in foreclosure that do not appear on the open market.

short sale When a lender is willing to accept less than the total amount due on a mortgage.

split loan When a second mortgage is taken out in order to avoid private mortgage insurance. Also called a *piggy-back loan*.

statement of record An explanation and description of existing and proposed improvements and services planned for residential land to be sold intra-state.

statutory period of redemption Period of time allowed after the sale of property for the borrower to redeem the loan and the property.

stop date The date on which the entire principal balance on a term loan must be paid.

streamline refinance A faster way to refinance FHA loans with less documentation and underwriting.

Streamlined Modification Program (SMP) A loan modification program initiated in 2008 for at-risk borrowers with Fannie Mae and Freddie Mac loans.

strict foreclosure Court establishes a specific time for the balance of the loan to be paid off; if not paid, full legal title is awarded to the lender. Rare today except in case of land contract.

subject to Becoming responsible, but not assuming personal liability, for an existing loan.

subordination An existing mortgage can be placed in an inferior position to a new mortgage given to another mortgagee and secured by the same collateral.

- subprime lenders** Lenders specializing in loans for less than credit-worthy borrowers; blamed for much of the financial crisis starting in 2007 due to adjustable-rate loans that borrowers were not able to make payments on when the ARM reset after two or three years.
- subprime market** Lenders specializing in loans to less-than-credit-worthy borrowers. This market grew rapidly in the early 2000s and declined when the overall housing market began to decline in 2006.
- subrogation** Taking a lesser position or interest.
- substitution of entitlement** One veteran can substitute entitlement when purchasing another veteran's property, releasing the original veteran borrower from all liability on the loan.
- suit to quiet title** A court action intended to establish or settle the title to a particular property, especially when there is a cloud on the title.
- survey** The process by which boundaries are measured and land areas are determined; the on-site measurement of lot lines, dimensions, and position of a house on a lot, including the determination of any existing encroachments or easements.
- tax increment financing** Allocates increased property tax revenues to pay for debts incurred in improving an area.
- Taxpayer Relief Act of 1997 (TRA '97)** A sweeping revision of the income tax code providing homeowners with exemptions from capital gains tax on the sale of personal residences.
- thrifts** Savings associations or savings banks; may be organized as either stock or mutual companies.
- title insurance** A policy insuring an owner or mortgagee against loss by reason of defects in the title to a parcel of real estate.
- title report** A search of public records to determine all interests in the property.
- title theory** Some states interpret a mortgage to mean that the lender is the owner of mortgaged land. Upon full payment of the mortgage debt, the borrower becomes the landowner.
- Torrens Certificate** Includes the state as guarantor of the title in case of a claim.
- total obligations ratio** Percentage of gross monthly income allowed for all housing expense plus monthly debt payments. Also called the *back-end ratio*.
- Treasury bills** Department of the Treasury short-term securities.
- Treasury bonds** Department of the Treasury long-term securities that run more than ten years.
- Treasury notes** Department of the Treasury intermediate-term securities that run two to ten years.
- tri-merge credit report** Combines information from Experian, Equifax, and Trans-Union; required by most lenders.
- Troubled Asset Relief Program (TARP)** Establishes and manages a Treasury fund in an attempt to curb the ongoing financial crisis of 2007.
- trust deed** A financing instrument in which the borrower/trustor conveys title into the hands of a third-party trustee to be held for the beneficiary/lender. When the loan is repaid, title is reconveyed to the trustor. If default occurs, the trustee exercises the power of sale on behalf of the lender/beneficiary. Also called a *deed of trust*.
- trustee** The appointed third-party operator of a trust.
- trustor** The originator of a trust.
- Truth in Lending Act (TILA)** Federal government regulates the lending practices of mortgage lenders through Regulation Z of this act, which requires full disclosure of all terms of credit, including the annual percentage rate (APR).
- underwriting** The process of evaluating borrower credit, collateral value, and the risks involved in making a loan.
- upside down or underwater** When borrower owes more than the current value of a property.
- usury** Charging interest at a higher rate than the maximum rate established by state law. Does not apply to mortgage loans.
- value in exchange** When its power to purchase other objects defines a property's value.
- value in use** When a specific use defines a property's value.
- vendee** A buyer, usually under the terms of a land contract.
- vendor** A seller, usually under the terms of a land contract.

voluntary lien A lien placed on property with the knowledge and consent of the property owner.

Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) Signed into law in July 2010; includes provisions anticipated to restore responsibility and accountability to the financial system, including establishing the Consumer Financial Protection Bureau.

warehouse of funds Funds committed by a commercial bank that mortgage brokers can draw on, enabling them to close individual home loans that may become part of a larger package.

weighted average An appraiser may assign percentages to illustrate the importance of one appraisal approach over another.

workouts Efforts made by a lender to avoid foreclosure, including payment waivers, refinancing, and loan modifications.

zero-coupon bonds A bond purchased at a discount and redeemed after a stated period of time for full value; patterned after World War II savings bonds.

Answer Key

REVIEW QUESTION ANSWERS

Chapter 1: The Nature and Cycle of Real Estate Finance

- c. The construction industry affects millions of people in related industries.
- b. Disintermediation occurs when more funds are withdrawn than are deposited, resulting in a net loss of deposits, a cutback in lending, and a slowdown in the economy.
- c. In the concept known as hypothecation, the borrower is the legal owner; the lender has rights only after a loan default.
- a. Leverage makes use of borrowed funds to finance the major portion of a purchase.
- d. Federal and related agencies are the largest holders of outstanding mortgage debt today.
- c. The impact of local activities will always have the greatest effect on property values.
- a. The majority of households are married couples, but a large number are single-person households.
- b. A greater demand will generally lead to increased home prices.
- d. The birth rate is actually lower.
- b. In order to qualify for the capital gains tax exemption, an individual or couple must have lived in their home a total of two of the past five years.

Chapter 2: Money and the Monetary System

- c. The value of money is based on trust and confidence in the United States.
- b. When interest rates are higher, the banks lend less money for spending.
- b. Because rapid inflation or a slide into recession has the most impact on the economy, the Fed's primary short-term goal is to combat inflationary or deflationary pressures.
- c. When the reserve requirements are lowered, commercial banks have more money available for lending.
- b. The Federal Reserve discount rate is the amount of interest charged to banks for borrowed funds.
- d. The Truth in Lending Act, also called TILA (Regulation Z), is administered by the Fed.
- d. $8.00\% + 0.75\% = 8.75\%$.
- b. Treasury departments are responsible for collecting funds and paying bills to keep federal agencies in operation.
- c. Treasury bonds run for more than ten years; Treasury bills are less than one year; Treasury notes are two to ten years.
- c. FDIC provides insurance for deposits in banks and thrifts.

Chapter 3: Additional Government Influence

1. c. Fannie Mae is now under the control of the Federal Housing Finance Agency.
2. c. The Interstate Land Sales Act only pertains to land sales made out of state, not land marketed locally.
3. c. The Housing Choice Voucher Program allows the Public Housing Authority to use some of its allotted funds to provide mortgage payment assistance to qualified applicants.
4. b. The Equal Credit Opportunity Act (ECOA) forbids seeking information about childbearing capability.
5. d. Right of rescission is covered under the Truth in Lending Act rather than RESPA.
6. d. Regulation Z requires full disclosure of all aspects of financing if any one element is advertised.
7. b. Lenders are required to provide credit for all qualified persons in the community served.
8. b. IRBs are used to encourage incoming business to the community; an industrial or office park is an ideal application of IRB monies.
9. a. NSP grants are for the purchase and redevelopment of abandoned or foreclosed properties.
10. d. FCS provides credit in rural, not urban, areas.

Chapter 4: The Secondary Mortgage Market

1. d. The sale of mortgage-backed securities using loan packages as collateral provides funds.
2. d. The administered price system replaced the free market auction system.
3. a. LTV higher than 80% requires mortgage insurance.
4. b. Any loan that does not meet Fannie Mae/Freddie Mac guidelines is nonconforming.
5. c. Ginnie Mae is administered by HUD and is not a GSE.
6. b. Freddie Mac was chartered to purchase conventional loans from savings associations and thrifts and now purchases both government and conventional loans.
7. d. As part of the Economic and Housing Recovery Act of 2008, Freddie Mac came under the supervision of the Federal Housing Finance Agency (FHFA) and in September 2008 was placed in conservatorship along with Fannie Mae.
8. d. Ginnie Mae guarantees payment to investors on FHA/VA mortgage-backed securities.
9. d. The FHA comes under the supervision of HUD, not FHFA.
10. c. A real estate mortgage investment conduit (REMIC) is made up of multiple classes of ownership interests in a single pass-through tax authority.

Chapter 5: Sources of Funds: Institutional, Non-Institutional, and Other Lenders

1. d. Checking accounts provide more than savings accounts, loans, or equity.
2. c. Single-family home loans are generally issued for 30-year amortizations.
3. b. Commercial banks specialize in short-term construction loans.
4. b. Mutual savings banks originated in the early industrial areas of the Northeast.
5. c. Life insurance companies are more interested in larger, long-term projects, not home mortgage loans.
6. b. Mortgage brokers do not service the loan after settlement.
7. a. Mortgage bankers originate the loan and service the loan after settlement.
8. a. Through warehousing, the local commercial bank provides short-term financing to generate funds.
9. a. A real estate investment trust (REIT) provides income generated from the property itself.
10. b. A real estate mortgage trust (REMT) generates income from mortgage loans.
11. c. Municipal bonds are issued by a city, county, or state.
12. c. Registered bonds may be cashed in only by the registered owner.
13. c. If the market rate increases, the value of the lower interest rate bonds decreases.
14. c. Income from a REIT is taxed at the beneficiary level only.

Chapter 6: Instruments of Real Estate Finance

1. a. The owner of the property chooses to place a mortgage lien.
2. d. Property taxes will take precedence over other liens.
3. a. The increased foreclosure power is very attractive to a lender.
4. c. An unsecured note is an independent debt instrument without collateral.
5. c. The defeasance clause provides the mortgagor with clear title when the loan is paid off.
6. c. In a contract for deed, title does not convey until all terms have been met.
7. a. A due-on-sale clause requires that the loan be paid off when the property is conveyed.
8. b. Purchasing subject to an existing loan leaves the seller with liability.
9. c. The release clause enables the developer to give clear title on each sale.
10. b. Lenders temporarily waiving payments run less risk that they will lose first rights.

Chapter 7: Real Estate Financing Programs

1. b. Most people like the security of a fixed-rate loan and the lower monthly payment of a 30-year loan compared to a 15-year loan.
2. b. When the equity reaches 22% of the original value, the PMI must be dropped.
3. b. On the 80/15/5 split loan, the first mortgage will be \$240,000, second mortgage \$45,000, and down payment \$15,000.
4. b. $\$80,000 \div 12 = \$6,666.67 \times 36\% = \$2,400$.
5. d. Subprime lenders are not necessarily predatory but do make it possible for those with poor credit to obtain a mortgage loan, although at higher-than-market interest rates.
6. d. The cost of refinancing should be recoverable in two years.
7. c. The 2/6 cap limits to 6 the increase over the life of the loan: $3.5 + 6 = 9.5\%$.
8. b. The reverse annuity mortgage would provide the couple with income.
9. c. The lender disperses funds as the work is completed to protect the lender's interest.
10. c. The installment sale may provide a tax advantage for the individual.
11. b. In a lease-purchase, financial negotiations are often entered into prior to final settlement.
12. c. Under IRS Section 1031, equal value is not necessary, but equities in the property must be balanced.
13. d. In a joint venture, each party brings individual expertise to a specific project.

Chapter 8: Government Loans

1. c. Because the government insured the full amount of the loan, lenders were willing to make loans with low down payments.
2. b. One of HUD's main functions is the administration of FHA.
3. c. A mortgage insurance premium provides funds to protect FHA from losses due to foreclosures.
4. d. The seller may not provide any part of the 3.5% required from the borrower.
5. b. The Home Equity Conversion Mortgage (HECM) was developed as an option for elderly homeowners.
6. c. The annual renewal payment is calculated as a percentage of the total loan, divided by 12 and added to the monthly PITI payment.
7. a. The FHA 203(k) loan covers both the purchase and rehabilitation of a property.
8. d. The lender considers the guaranteed VA entitlement the same as 25% down.
9. c. The Certificate of Eligibility is issued by the Department of Veterans Affairs on request.
10. b. Even if the seller opts to accept the CRV value as the sales price, the buyer is not obligated to purchase the property.
11. b. Current guarantee of $\$104,250 - \$46,000 = \$58,250 \times 4 = \$233,000$.
12. c. The funding fee provides the VA a pool of money for costs due to foreclosure.

Chapter 9: Processing Real Estate Loans

1. a. The borrower's ability to repay the loan is most important to the lender.
2. c. After seven or eight years, most people either sell or refinance.
3. a. The lender is very comfortable with a 2-to-1 assets-to-liabilities ratio.
4. a. High-income persons with a lax attitude about paying bills are a high risk.
5. a. The direct sales comparison approach is mostly used with residential properties.
6. b. As there are few comparables for churches, the cost approach is best.
7. b. All recorded instruments are considered to be constructive notice.
8. c. Most states require a mechanic's lien to be filed within less than a year.
9. c. The state maintains title records with the Torrens System.
10. b. If a seller is not able to resolve the problem, legal action in the form of a suit to quiet title may be taken.

Chapter 10: Defaults and Foreclosures

1. c. Both borrower and lender gain as property increases in value.
2. b. Any breach may result in the lender accelerating the total loan due.
3. b. In using forbearance or moratorium, the lender anticipates that the borrower will solve the current financial problem.
4. b. The equitable redemption period allows the borrower to bring the payments current or pay off the total due.
5. b. The lender will make an opening bid when suing on terms of mortgage.
6. a. It is hoped that forbearance will enable the borrower to return to a secure financial position.
7. c. In receiving the top portion of the loan, the lender is paid—by the VA—the difference between present value and the loan balance.
8. c. Avoiding the judicial procedure enables the lender to foreclose more rapidly.
9. c. If the contract for deed is worded carefully, the vendor may be able to exercise strict foreclosure.
10. b. The IRS sees the defaulted loan as a gain to the borrower.

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